

**EXPLANATION OF PROPOSED INCOME TAX TREATY  
BETWEEN THE UNITED STATES AND JAPAN**

Scheduled for a Hearing  
Before the  
COMMITTEE ON FOREIGN RELATIONS  
UNITED STATES SENATE

On October 29, 2015

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Prepared by the Staff  
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## CONENTS

	<u>Page</u>
INTRODUCTION .....	1
I. SUMMARY .....	2
II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES .....	4
A. U.S. Tax Rules .....	4
B. U.S. Tax Treaties .....	7
III. OVERVIEW OF JAPANESE TAX LAW .....	9
A. National Income Taxes .....	9
B. International Aspects of Domestic Japanese Tax Law .....	12
C. Other Taxes .....	15
IV. ECONOMIC OVERVIEW .....	16
A. Introduction .....	16
B. Overview of Economic Activity Between the United States and Japan .....	18
V. EXPLANATION OF PROPOSED PROTOCOL .....	26
Article I .....	26
Article II .....	26
Article III .....	26
Article IV .....	27
Article V .....	29
Article VI .....	30
Article VII .....	31
Article VIII .....	31
Article IX .....	31
Article X .....	33
Article XI .....	34
Article XII .....	37
Article XIII .....	40
Article XIV .....	43
Article XV .....	43
VI. U.S. MODEL TREATY AS A REFLECTION OF U.S. TAX POLICY .....	45
A. Mandatory Arbitration .....	45
B. Mutual Collection Assistance Under Present Law .....	50

## INTRODUCTION

This pamphlet,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, describes the protocol to amend the income tax treaty and protocol currently in force between the United States and Japan (the “proposed protocol”). The proposed protocol was signed on January 24, 2013, and, when ratified, will amend the income tax treaty and protocol between the United States and Japan (respectively, the “existing treaty” and “2003 Protocol”) signed on November 6, 2003. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol for October 29, 2015.<sup>2</sup>

Part I of the pamphlet provides a summary of the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III provides a brief overview of the tax laws of Japan. Part IV provides a discussion of investment and trade flows between the United States and Japan. Part V explains, in order, each article of the proposed protocol. Part VI describes issues that members of the Committee on Foreign Relations may wish to consider in their deliberations over the proposed protocol.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Japan* (JCX-136-15), October 28, 2015. References to “the Code” or “sections” are to the U.S. Internal Revenue Code of 1986, as amended. This document is available on the internet at <http://www.jct.gov>.

<sup>2</sup> For a copy of the proposed protocol, see Senate Treaty Doc. 114-1.

## I. SUMMARY

The principal purposes of the proposed protocol are to reduce or eliminate double taxation of income earned by residents of each country from sources within the other country, and to prevent avoidance or evasion of the taxes of the two countries. The proposed protocol also is intended to promote closer economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries. As in other U.S. tax treaties, these objectives 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.

Article II provides that companies that are resident in both Japan and the United States (dual resident companies) will not be considered resident of either jurisdiction for purposes of the treaty. As a result, the treaty benefits available to such companies are limited to those that are available to nonresidents.

In Article III, the proposed protocol reduces the ownership threshold for elimination of source-country taxation of dividends received by a resident of one treaty jurisdiction from company resident in the other treaty country to at least 50 percent of the voting stock of the company paying the dividends. Article III also reduces the required holding period for elimination of source-country taxation on such dividends to the six-month period ending on the date on which entitlement to the dividends is determined.

Article IV replaces Article 11 of the existing treaty, regarding taxation of cross-border interest payments. Under the revised rules, interest arising in one treaty jurisdiction and paid to a beneficial owner who is resident in the other treaty jurisdiction is generally subject to tax only in the residence country. Anti-abuse provisions are provided for contingent interest payments and for certain payments with respect to ownership in entities used for securitization of real estate mortgages.

Article V revises the definition of real property in Article 13 of the existing treaty to conform more closely to the U.S. Model treaty.

Article VII repeals Article 20 of the existing treaty, which provides certain benefits to researchers and teachers from one jurisdiction when they are temporarily present in the other jurisdiction, consistent with modern treaty policy of both the United States and Japan. A conforming change is made by Article I to paragraph 5 of Article 1 of the existing treaty.

Article IX revises the rules regarding foreign tax credits to conform to changes in Japanese statutory rules for relief from double taxation. The changes reflect the recent adoption of a participation exemption system in Japan.

Article X revises the nondiscrimination rules of Article 24 of the existing treaty to reflect the changes to Article 11, as summarized above.

Article XI amends the mutual agreement procedure, which presently allows arbitration at the discretion of the competent authorities, by prescribing mandatory and binding arbitration in cases in which the competent authorities are unable to reach agreement. The article prescribes

standards similar but not identical to those found in recent treaties with Belgium, France, Germany, and Canada. Inclusion of a requirement for mandatory arbitration departs from the U.S. Model treaty.<sup>3</sup> The proposal also departs from the U.S. Model rules regarding mutual agreement procedures generally, in that it does not require that the presenter of the case have filed a return with each of the two jurisdictions and allows the taxpayer who presents a case to submit a position paper directly to the arbitration panel. It also may expedite the schedule on which a taxpayer who seeks a bilateral advanced pricing agreement may contest a proposed adjustment that is related to the subject of the pending request for a pricing agreement, thus compelling arbitration if the competent authorities do not reach agreement on the bilateral advanced pricing agreement.

The proposed protocol revises the administrative assistance provisions of the existing treaty in two ways. First, Article XII of the proposed protocol modernizes the exchange of information provisions of Article 26 to conform to recent standards of transparency. Second, Article XIII expands the mutual collection assistance available under Article 27. With respect to the latter, the changes to the scope of collection assistance are similar to those in only five other tax treaties.

Article XIV amends the 2003 protocol to conform to the above changes and to add paragraphs needed to implement the mandatory arbitration and the mutual collection assistance provisions. Other changes are also made in the proposed protocol to correct language errors in the existing treaty and to update references to relevant domestic laws named in the existing treaty.

The rules of the proposed protocol generally are similar to rules of recent U.S. income tax treaties, the U.S. Model treaty, and the 2014 Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (the “OECD Model treaty”).<sup>4</sup> The proposed protocol does, though, include certain substantive deviations from these treaties and models. Significant deviations are noted throughout the explanation of the proposed protocol in Part V of this pamphlet and are discussed in Part VI.

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<sup>3</sup> The full text of the Model United States Income Tax Convention, with the accompanying Technical Explanation, published November 15, 2006, is available at <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/international.aspx>.

<sup>4</sup> OECD (2014), Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing. [http://dx.doi.org/10.1787/mtc\\_cond-2014-en](http://dx.doi.org/10.1787/mtc_cond-2014-en). The OECD Model treaty is a consensus document that is intended to settle issues of double taxation as well as to ensure that inappropriate double nontaxation results. The multinational organization was first established in 1961 by the United States, Canada and 18 European countries, dedicated to global development, and has since expanded to 34 members.

## II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

### A. U.S. Tax Rules<sup>5</sup>

The United States has a worldwide tax system under which U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. The United States does not impose an income tax on foreign corporations on income earned from foreign operations, whether or not some or all its shareholders are U.S. persons. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. U.S. shareholders of foreign corporations are taxed by the United States when the foreign corporation distributes its earnings as dividends or when a U.S. shareholder sells its stock at a gain. Thus, the U.S. tax on foreign earnings of foreign corporations is “deferred” until distributed to a U.S. shareholder or a U.S. shareholder recognizes gain on its stock.

However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the CFC rules of subpart F<sup>6</sup> and the PFIC rules.<sup>7</sup> A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation’s income under one of the anti-deferral regimes.<sup>8</sup>

With respect to nonresident alien individuals or foreign corporations, the U.S.-source fixed or determinable annual or periodical income (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are

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<sup>5</sup> The U.S. tax rules are codified in Title 26, of the United States Code, referred to as the Internal Revenue Code of 1986, as amended (“IRC”). Unless otherwise stated, all section references in this document are to the IRC.

<sup>6</sup> Secs. 951-964.

<sup>7</sup> Secs. 1291-1298.

<sup>8</sup> Secs. 901, 902, 960, 1293(f).

subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected through withholding. Certain payments of U.S.-source income paid to foreign financial institutions and other foreign entities also are subject to withholding tax at a rate of 30 percent unless the foreign financial institution or foreign entity is compliant with specific reporting requirements.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two principal exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Notwithstanding this general rule that dividends and interest are sourced based upon the residence of the taxpayer making such a payment, special rules may apply in limited circumstances to treat as foreign source certain amounts paid by a U.S. resident taxpayer and treat as U.S. source certain amounts paid by a foreign resident taxpayer.<sup>9</sup> Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a “per-country” basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to credits for foreign oil and gas taxes.

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<sup>9</sup> For example, certain payments of interest by a foreign bank branch or foreign thrift branch of a domestic corporation or partnership as foreign source. Similarly, several rules apply to treat as U.S. source certain payments made by a foreign resident. For example, certain interest paid by a foreign corporation that is engaged in a U.S. trade or business at any time during its taxable year or has income deemed effectively connected with a U.S. trade or business during such year is treated as U.S. source.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

## B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. The U.S. Model treaty, published in 2006 with an accompanying Technical Explanation by the Department of Treasury, reflects the most recent comprehensive statement of U.S. policy with respect to tax treaties.<sup>10</sup> To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned within its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the country in which income is derived (the "source country") in treaties are premised on the assumption that the country of residence of the taxpayer deriving the income (the "residence country") may tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country may tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other are not required to pay tax in that other country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings in excess of a specified amount). Treaties address the taxation of passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that the income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on the income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate

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<sup>10</sup> The U.S. Model treaty has been updated periodically. For a comparison of the U.S. Model treaty with its 1996 predecessor, see Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007. Several revisions and additions to the U.S. Model treaty were announced on May 20, 2015, for public comment, but a complete revised model has not been published. The proposals are available at <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/international.aspx>.

it entirely) in return for reciprocal treatment by its treaty partner. In particular, under the U.S. Model treaty and many U.S. tax treaties, source-country taxation of most payments of interest and royalties is eliminated, and, although not provided for in the U.S. Model treaty, many recent U.S. treaties forbid the source country from imposing withholding tax on dividends paid by an 80-percent owned subsidiary to a parent corporation organized in the other treaty country.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it allows a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when the information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. Several recent treaties and protocols provide that, notwithstanding the general treaty principle that treaty countries are not required to take any actions at variance with their domestic laws, a treaty country may not refuse to provide information requested by the other treaty country simply because the requested information is maintained by a financial institution, nominee, or person acting in an agency or fiduciary capacity. This provision thus explicitly overrides bank secrecy rules of the requested treaty country. The Internal Revenue Service (“IRS”) and the treaty partner’s tax authorities also can request specific tax information from a treaty partner. These requests can include information to be used in criminal tax investigations or prosecutions.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a “competent authority” mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments. Several recent treaties also provide for mandatory arbitration of disputes that the competent authorities are unable to resolve by mutual agreement.

Treaties generally provide rules to ensure that nationals and residents of a Contracting State may not be subject, directly or indirectly, to discriminatory taxation in the other Contracting State. Under the nondiscrimination rules, neither country may subject nationals or residents of the other country to taxation that is more burdensome than the tax it imposes on its own nationals or enterprises in the same circumstances.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain “anti-treaty shopping” provisions designed to limit treaty benefits to bona fide residents of either of the two countries.

### III. OVERVIEW OF JAPANESE TAX LAW<sup>11</sup>

#### A. National Income Taxes

##### Overview

Japan is a parliamentary government with a constitutional monarchy, operating under a constitution that became effective in 1947. It is a member of many of the same international organizations as the United States, including those with regional significance, the Asia-Pacific Economic Cooperation Forum (APEC) and the Association of Southeast Asia Nations (ASEAN) Regional Forum. Japan has participated in the negotiations to form a Trans-Pacific Partnership trade agreement since 2013.<sup>12</sup> The central government is organized through a bicameral legislative body, the Diet, which selects the prime minister. The country is divided into 47 administrative units or prefectures.

Japanese law treats individual income taxes and corporation income taxes separately, under the Income Tax Law and the Corporation Tax Law, respectively. The Special Tax Measures Law may modify or supplement the general principles in these basic laws. The Japanese income tax system and general rules are broadly similar to the U.S. income tax system and reflect many of the same complexities, including rules for defining the tax base, deductions, depreciation, credits, and timing. Many types of income, including interest, dividends, and employment income (for individuals) are subject to withholding at the source.

##### Individuals

For individuals resident in Japan, income tax is assessed primarily on the basis of an individual's combined income. Income tax for retirement income (a lump-sum payment at retirement) and timber income is calculated separately. Certain income is subject to special rules and may be separately taxed under the Special Tax Measures Law. The rate structure for national income tax is progressive and extends from five percent for taxable income under 1,950 million yen (approximately \$16,300) to 45 percent for taxable income over 40 million yen

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<sup>11</sup> The information in this section relates to Japanese law and is based on the Joint Committee staff's review of secondary sources. See Bloomberg BNA, *Global Tax Guide, Asia/Pacific, Japan*, July 23, 2015, available online at <https://www.bloomberglaw.com/document/X2MJF2H8>; Takagi, 7200 T.M., *Business Operations in Japan*, 2013; R. Saw, *Japan - Corporate Taxation*, Country Surveys IBFD, January 2, 2015; R. Saw, *Japan - Individual Taxation*, Country Surveys IBFD, January 2, 2015; E. N. Rose, *Japan - Corporate Taxation*, Country Analyses IBFD, January 1, 2015; E. N. Rose, *Japan - Individual Taxation*, Country Analyses IBFD, January 1, 2015. The Law Library of Congress Global Legal Research Center has reviewed this description for accuracy.

All currency conversions are based on a rate of 119 yen to one dollar, at [www.xe.com](http://www.xe.com), as of October 19, 2015.

<sup>12</sup> U.S. State Department "U.S. Relations with Japan Fact Sheet," at <http://www.state.gov/r/pa/ei/bgn/4142.htm>.

(approximately \$335,000).<sup>13</sup> There is also a national reconstruction surtax that is 2.1 percent of the national income tax rate, and a local inhabitant tax that is 10 percent of taxable income.

Certain interest, including from bank deposits and government bonds, is separately taxed and withheld at the source. The tax rate is 20.3 percent (15.3 percent for national income tax and the reconstruction surtax, and five percent local tax).

Dividend income is generally aggregated with other sources of income and taxed at progressive rates. Non-listed companies are required to withhold tax at 20.4 percent (20 percent of which is national income tax plus the reconstruction surtax) from the gross amount of the dividend payment, and the withheld tax amount is deducted from the tax imposed on the aggregated income of an individual who receives a dividend subject to this withholding tax. Dividends from listed companies are taxed at 20.3 percent (15.3 percent for national income tax and the reconstruction surtax, and five percent local tax), which is also withheld at the source. Individuals may elect to exclude dividends from listed companies from aggregate income.

Among capital gains of various assets, capital gains from the sale of certain securities may be taxed similarly to dividend income. Capital gains from the sale of land and buildings are taxed at various rates and are subject to different deduction amounts, depending on the use of the property and whether the holding period qualifies as long-term (five years or more). Other capital gains are added to aggregate income. In the case of long-term capital gain, 50 percent is subject to tax.

### Corporations

In general, corporations and all private business entities established in Japan are subject to corporate income taxation on their worldwide income. Income earned by foreign subsidiaries and dividends from foreign subsidiaries, however, is generally not included in a Japanese parent company's tax base.

The general national corporate tax rate is 23.9<sup>14</sup> percent.<sup>15</sup> Small and medium corporations with contributed capital of no more than 100 million yen (approximately \$838,000) are taxed at 19 percent<sup>16</sup> on their annual net taxable income up to eight million yen (approximately \$67,000), and 23.9 percent on remaining taxable income. Corporations are

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<sup>13</sup> There are also general allowances available for resident individuals, and allowable deductions against taxable income for items such as casualty losses, medical expenses, social insurance premiums, life insurance premiums, earthquake insurance premiums, and charitable donations. The basic deduction for taxpayers is 380,000 yen (approximately \$3,193).

<sup>14</sup> For fiscal years beginning before April 1, 2015, the rate is 25.5 percent.

<sup>15</sup> Taking into account all national and local taxes, the effective corporate statutory rate is generally 32.11 percent for the 2015 fiscal year, and 31.33 percent for the 2016 fiscal year.

<sup>16</sup> This rate is reduced to 15 percent for tax years beginning before April 1, 2017.

subject to an additional size-based business tax. A special surtax, which is suspended through March 31, 2017, is imposed on corporate capital gains from the sale of land located in Japan.

Dividends received from another domestic corporation are fully or partly excluded from the corporate income tax base depending on the ratio in which the dividend-receiving corporation owns the dividend-paying company's shares. Interest received is fully taxed. Dividends and interest are subject to a withholding tax at the rate described in the previous section describing individual income tax, but the tax is generally creditable against corporate tax liability and excess payments are refundable.

Japan provides corporate consolidation for 100-percent-owned domestic corporate groups. Group taxation rules automatically apply to domestic companies with a 100 percent relationship, but foreign parent companies or subsidiaries may not participate in consolidated tax filing or group taxation. Dividends received from a 100-percent-owned domestic subsidiary are exempt from corporate tax, and no gains or losses are recognized on asset transfers within a 100-percent-owned group.

## **B. International Aspects of Domestic Japanese Tax Law**

### Residency

Japanese tax law provides different treatment for permanent residents, non-permanent residents, and nonresidents. For tax purposes, a resident is any person who has a domicile in Japan or has resided in Japan continuously for more than one year. A resident is non-permanent for tax purposes if the resident is not a Japanese national but has lived in Japan for five years or less, cumulatively, in the last 10 years. A nonresident is an expatriate residing in Japan for less than one year.

A domestic company is a company whose head office or main office is in Japan.<sup>17</sup> Foreign companies are companies other than domestic companies.

### Individuals

Permanent resident individuals are subject to tax on their income wherever paid or derived. Non-permanent residents are subject to income tax on Japan-source income and on income from other sources paid in Japan or remitted to Japan from abroad.

Nonresident individuals are typically subject to tax only on income from sources within Japan. Passive income, such as dividends and interest, is subject to withholding tax. Dividends are generally subject to withholding tax at a 20.4 percent rate, and the rate for certain listed shares is 15.3 percent. Interest on bonds is generally subject to a 15.3 percent withholding tax. Interest on loans used for operating a business in Japan is subject to a 20.4 percent withholding tax. Royalties paid to nonresidents are subject to withholding tax at 20.4 percent. Sales proceeds from Japanese real property are subject to withholding tax at a rate of 10.2 percent. Nonresident individuals are generally not subject to Japanese income tax on capital gains, other than gains from real property and securities.

### Domestic companies

Domestic companies are subject to tax on their worldwide income. There is, however, a 95-percent exemption from corporate tax for dividends received by a domestic company from a foreign subsidiary (the Foreign Dividend Exclusion Rule), with the exception that certain Japanese shareholders must report currently any undistributed profits of “designated tax haven subsidiaries.”<sup>18</sup>

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<sup>17</sup> Therefore, all Japanese incorporate companies are resident because a company incorporated in Japan under the Company Law, Civil Code, or other special laws must have its head office or main office in Japan. The effective place of management or nationality of shareholders is not relevant for determining residence under Japan’s tax law.

<sup>18</sup> A designated tax haven subsidiary is a foreign company in which more than 50 percent of the shares are owned directly or indirectly by Japan residents, and which is either not subject to any income taxation in its home jurisdiction or is subject to an effective tax rate of 20 percent or less, as computed under Japan’s tax accounting rules. A designated tax haven subsidiary may be fully or partially excluded from this regime if it satisfies (1) a

## Foreign/nonresident companies

Foreign (non-domestic, or nonresident) companies are subject to Japanese income tax only on their income from sources in Japan. Foreign companies not having a permanent establishment in Japan are subject to withholding tax on gross payments as described in the prior section about nonresident individuals.

## Permanent establishment

If a nonresident individual or foreign company has a permanent establishment in Japan, the business income that the nonresident derives is subject to income tax on a net basis at progressive rates.<sup>19</sup> A foreign corporation or nonresident individual with a permanent establishment in Japan is also subject to Japanese net basis income tax on all other Japan-source income, such as investment income, under the “force of attraction” rule. Effective on April 1, 2016, however, the force of attraction rule will be replaced by the “attributable income method.” Domestic-source income attributable to the business or activities of the permanent establishment will be subject to net basis income tax, and other Japan source income not attributable to the permanent establishment may be subject to gross basis withholding tax under the rules described previously.

## Controlled foreign corporation rules

Japanese tax law provides special rules pertaining to foreign corporations that are 50 percent owned, directly or indirectly, by domestic corporations and residents (controlled foreign corporations, or “CFCs”). The “anti-tax-haven” rule provides that allocable shares of undistributed income of a CFC is attributed, in the year in which it is derived (and irrespective of whether it is distributed), to any domestic corporation owning directly or indirectly 10 percent or more of the stock of a CFC if the tax burden of the foreign subsidiary is 20 percent or less.<sup>20</sup>

## Foreign tax credits and double tax relief

Japanese tax law allows relief from double taxation of domestic corporations and resident individuals through a foreign tax credit. Foreign tax credits are subject to an overall limitation generally equal to the product of Japanese income tax multiplied by the ratio of foreign source income to taxable income. Surplus foreign tax credits and tax credit limitations may be carried

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business test; (2) a substance test; (3) an administration and control test; and (4) either an independence test or a local business test.

<sup>19</sup> Japan’s tax law provides for three types of permanent establishment: a branch, factory, or fixed place of business. In general, the application of this definition does not differ from the application of the term “permanent establishment” in Japan’s tax treaties.

<sup>20</sup> See previous discussion of “designated tax haven subsidiaries.” In general, income earned by a domestic corporation’s foreign subsidiaries is not currently included in the tax base of the parent corporation until repatriated via dividends or liquidation proceeds.

forward for three years. A taxpayer may elect to deduct foreign taxes for a taxable year in lieu of claiming the foreign tax credit.

### C. Other Taxes

In addition to the national income taxes described above, other taxes are levied at the national or local levels. Additional national taxes include a broad based (VAT-type) consumption tax; excise taxes on gasoline, other fuels, liquor, tobacco and certain other items; inheritance and gift taxes; land value tax; registration and license taxes; and stamp tax.

Prefectural inhabitant tax, municipal inhabitant tax, and enterprise tax are taxes on income collected at the local level, but subject to the general rules and rate limits prescribed by the Local Tax Law (enacted by the national government). The bases for the individual and corporate inhabitant taxes are almost the same as those of the corresponding national income taxes. For individuals, the inhabitant tax rate on ordinary income is a flat rate of 10 percent, and there are different rates for capital gains. The aggregate rates for the inhabitant taxes vary from approximately 13 to 16 percent for corporations, depending on the size and location of the business. The enterprise tax rates vary from approximately three to five percent for individuals and three to seven percent for corporations, plus an added value levy and capital levy for corporations.

From 2013 to 2037, a special reconstruction surtax of 2.1 percent applies to corporate and individual income tax liability, including withholding tax on dividends, interest, royalties, and employment income.<sup>21</sup> A foreign taxpayer eligible for the benefits of a Japanese income tax treaty may be exempt from this tax.

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<sup>21</sup> This surtax is a special tax measure for the Tohoku earthquake reconstruction. It will continue until 2037.

## IV. ECONOMIC OVERVIEW

### A. Introduction

Tax treaties can be viewed as part of a set of economic arrangements, such as trade agreements and bilateral investment treaties, reached between two countries to reduce the economic cost of conducting cross-border economic activity. Trade agreements, for example, may promote commerce between countries by lowering tariffs that countries impose on goods and services imported from another country. Trade agreements may also support cross-border commerce through non-tariff measures, such as the establishment of dispute resolution mechanisms.

Like trade agreements, tax treaties reduce the cost of conducting cross-border economic activity, but focus on limiting tax-related costs rather than tariff-related costs. By clarifying the assignment of taxing authority between residence and source countries and eliminating the double taxation of income, tax treaties reduce the uncertainty individuals and businesses may face when deciding to work or invest in another country and can increase after-tax returns to economic activity in cases where income may have been subject to double taxation or higher rates of withholding tax. For example, consider a business resident in a country where all income is taxed at a 15 percent rate, and assume the country has not concluded a tax treaty with the United States. The business is contemplating an investment opportunity in the United States where the economic returns come in the form of dividend payments, which are subject to a 30-percent gross-basis withholding tax in the United States. In the absence of a tax treaty, the dividends received by the business are taxed by the United States at 30 percent on a gross basis and subject to no further home-country tax. However, if the United States pursues a treaty with the country in which the business is resident, and the treaty eliminates withholding tax on dividend payments, then the dividends the business receives as part of its investment are subject to only home-country tax at 15 percent, thereby increasing the after-tax return on its investment and making the investment opportunity more attractive. Furthermore, the business may find the investment more attractive if there is a formal mechanism to address disputes over taxing authority between its country of residence and the United States, which alleviates concerns over double taxation and reduces uncertainty over the business's overall tax payment on its investment.

Tax treaties are often concluded between countries that already have significant economic ties and have historically preceded, rather than followed, trade agreements, which suggests that the conclusion of a tax treaty between two countries may provide some foundation for future economic agreements.<sup>22</sup>

The effect of tax treaties on economic activity between countries is ambiguous. On the one hand, tax treaties can lead to a more efficient allocation of labor and capital between countries to the extent that they eliminate or reduce tax-related barriers to economic activity. The existence of a tax treaty between two countries can also have an indirect effect on

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<sup>22</sup> Peter Egger and George Wamser, "Multiple Faces of Preferential Market Access: Their Causes and Consequences," *Economic Policy*, vo. 28, no. 73, January 2013, pp. 143-187.

investment because the scope of a country's tax treaty network can influence decisions to invest in that country. However, a given tax treaty's economic impact depends on the character and volume of capital and labor flows between treaty countries and the scope for double taxation of income in the absence of a tax treaty. If the scope for double taxation is limited, then tax treaties may not be expected to have a significant impact on cross-border economic activity.<sup>23</sup> Moreover, for particular industries, tax treaties may cause investment to shift from one treaty country to the other treaty country, just as lower barriers to trade may cause a shift in how businesses make investment and employment decisions between countries. This shift in investment may result in a more globally efficient allocation of investment but less investment in a particular treaty country.

The empirical research on the economic effects of tax treaties has not yielded conclusive results. On the one hand, a number of papers find that tax treaties have no or negative effect, and the International Monetary Fund's review of this literature suggests, at least for developing countries considering tax treaties with developed countries, that whatever economic benefit may arise from potential increases in foreign direct investment in the resulting from a tax treaty may be offset by foregone tax revenue that results from limits on source-country taxation;<sup>24</sup> the amount of capital that flows from a developed country to a developing country is, in general, substantially greater than the amount of capital that flows from a developing country to a developed country. On the other hand, some studies suggest that treaties have positive impacts on cross-border investment.<sup>25</sup> One paper finds that, by facilitating the resolution of transfer pricing disputes, the mutual agreement procedures in tax treaties can be particularly beneficial for multinational firms that use inputs whose arm's-length prices are difficult to determine.<sup>26</sup> Other papers find that while tax treaties encourage entry by firms in a particular country, they have little impact on firms that already have a presence in the country.<sup>27</sup> In other words, tax treaties may promote foreign direct investment, but largely through new investment by firms that are first entering the market and not through increased investment by firms that are already operating in the market.

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<sup>23</sup> The Treasury Department has indicated that establishing new tax treaties is partly determined by the scope of double taxation with respect to income generated from U.S. direct investment. See Testimony of Robert B. Stack, Treasury Deputy Assistant Secretary (International Tax Affairs), U.S. Department of the Treasury, Senate Committee on Foreign Relations Hearing on the Proposed Tax Protocol with Spain and the Proposed Tax Treaty with Poland, June 19, 2014, available at [http://www.foreign.senate.gov/imo/media/doc/Stack\\_Testimony.pdf](http://www.foreign.senate.gov/imo/media/doc/Stack_Testimony.pdf).

<sup>24</sup> International Monetary Fund, "Spillovers in Corporation Taxation," International Monetary Fund Staff Report, May 9, 2014.

<sup>25</sup> *Ibid.*

<sup>26</sup> Bruce A. Blonigen, Lindsay Oldenski, and Nicholas Sly, "The Differential Effects of Bilateral Tax Treaties," *American Economic Journal: Economic Policy*, vol. 6, no. 2, May 2014, pp. 1-18.

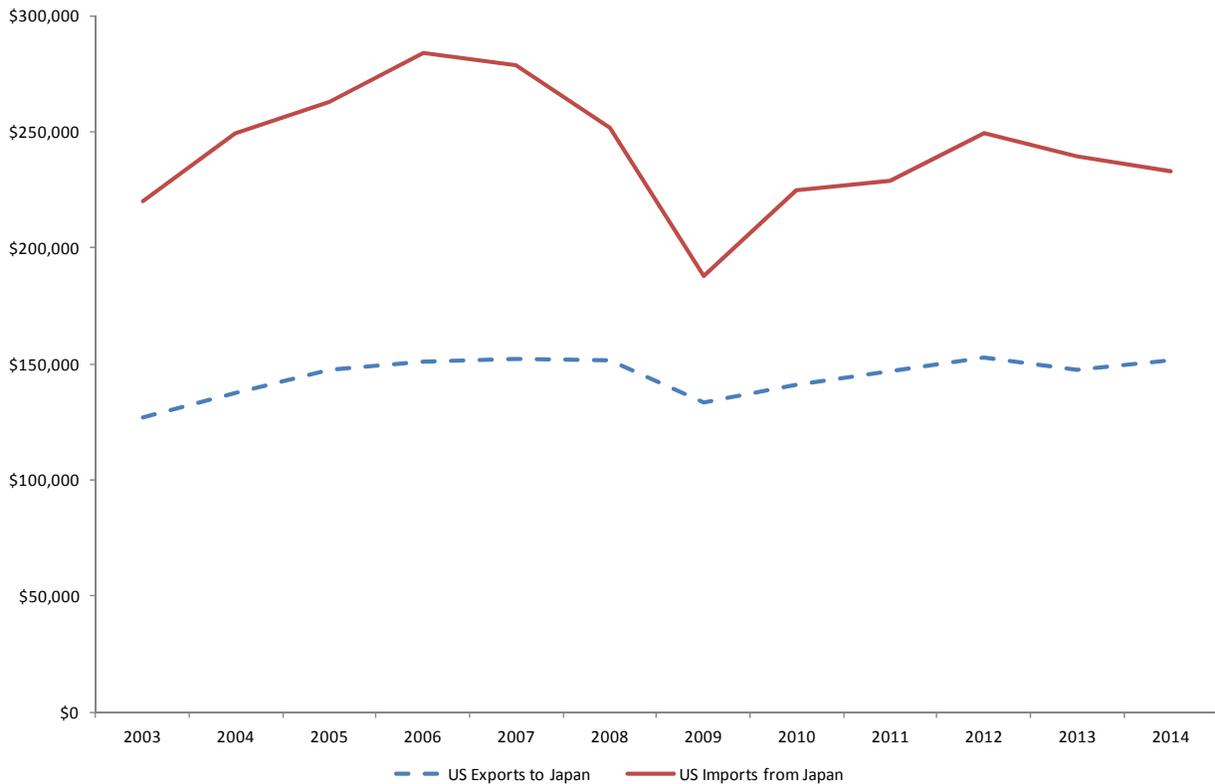
<sup>27</sup> See Ronald Davies, Pehr-Johan Norback, and Ayca Tekin-Koru, "The Effect of Tax Treaties on Multinational Firms: New Evidence from Microdata," *The World Economy*, vol. 32, January 2009, pp. 77-110, and Peter Egger, Simon Loretz, Michael Pfaffmayr, and Hannes Winner, "Bilateral Effective Tax Rates and Foreign Direct Investment," *International Tax and Public Finance*, vol. 17, December 2009, pp. 822-849.

## B. Overview of Economic Activity Between the United States and Japan

### Trade

With a gross domestic product (“GDP”) of \$4.6 trillion in 2014, Japan is the third largest economy in the world and one of the most significant trading partners of the United States.<sup>28</sup> Japan is the fourth largest destination for U.S. exports in the world. Figure 1, below, charts the volume of trade flows between the United States and Japan from 2003 to 2014 (in 2015 dollars).

**Figure 1.—U.S.-Japan Trade Flows, 2003-2014,  
(in 2015 Dollars)**



Source: Department of Commerce (Bureau of Economic Analysis) and calculations by the staff of the Joint Committee on Taxation.

<sup>28</sup> International Monetary Fund, World Economic Outlook Database (October 2015), available at <http://www.imf.org/external/pubs/ft/weo/2015/02/weodata/index.aspx>. The United States is the largest economy in the world (GDP of \$17.4 trillion in 2014) followed by China (GDP of \$10.4 trillion in 2014). For additional comparison, the collective GDP of the countries in the European Union was \$18.5 trillion in 2014, and worldwide GDP was \$77.3 trillion.

In 2014, the United States exported \$114.7 billion in goods and \$46.7 billion in services to Japan.<sup>29</sup> The largest categories of U.S. exports of goods to Japan were capital goods, except automotive (\$22.9 billion); industrial supplies and materials (\$17.6 billion); and foods, feeds, and beverages (\$13.6 billion).<sup>30</sup> The largest categories of U.S. exports of services to Japan were travel (\$12.1 billion), transport (\$9.5 billion) and charges for the use of intellectual property (\$8.7 billion).<sup>31</sup>

Japan is the fourth largest source in the world for U.S. imports. The United States imported \$136.7 billion in goods and \$31.2 billion in services from Japan in 2014.<sup>32</sup> The largest categories of U.S. imports of Japanese goods were capital goods, except automotive (\$53.8 billion); automotive vehicles, parts, and engines (\$49.9 billion); and consumer goods, except food and automotive (\$9.4 billion).<sup>33</sup> The largest categories of U.S. imports of services from Japan were charges for the use of intellectual property (\$12.4 billion), transport (\$7.9 billion), and government goods and services (\$3.0 billion).<sup>34</sup>

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<sup>29</sup> Bureau of Economic Analysis. These figures are calculated for purposes of the current account and differ from figures reported in the monthly report on U.S. international trade in goods and services. Exports of goods and services are calculated on the basis of receipts.

<sup>30</sup> *Ibid.*

<sup>31</sup> *Ibid.* Charges for the use of intellectual property include charges for the use of proprietary rights (such as patents, trademarks, copyrights, industrial processes and designs including trade secrets, and franchises) as well as charges for licenses to distribute or reproduce (or both) intellectual property embodied in produced originals or prototypes (such as copyrights on books and manuscripts, computer software, and sound recordings) and related rights (such as for live performances and television, cable, or satellite broadcasts. For additional discussion see [https://www.bea.gov/international/pdf/bach\\_concepts\\_methods/Royalties%20and%20License%20Fees.pdf](https://www.bea.gov/international/pdf/bach_concepts_methods/Royalties%20and%20License%20Fees.pdf).

<sup>32</sup> *Ibid.* These figures are calculated for purposes of the current account and differ from those reported in the monthly report on U.S. international trade in goods and services. Imports of goods and services are calculated on the basis of payments.

<sup>33</sup> *Ibid.*

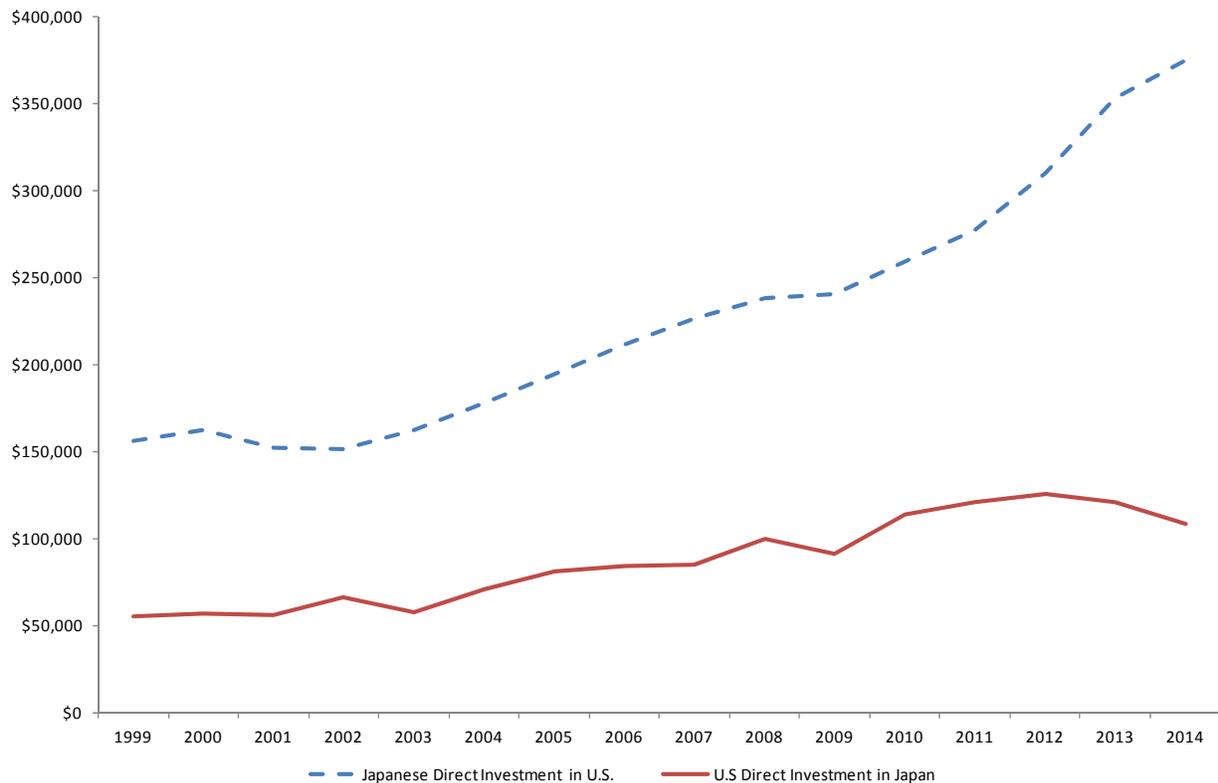
<sup>34</sup> *Ibid.* Government goods and services include services supplied by and to enclaves, such as embassies, military bases, and international organizations, as well as goods and services acquired from the host economy by diplomats, consular staff, and military personnel located abroad (as well as by their dependents). For discussion of other components of government goods and services, see <http://www.bea.gov/international/pdf/concepts-methods/ONE%20PDF%20-%20IEA%20Concepts%20Methods.pdf>.

## Foreign direct investment

### Japanese direct investment in the United States

As of 2014, Japanese direct investment in the United States totaled \$372.8 billion (historical cost).<sup>35</sup> Figure 2, below, shows how the stock of Japanese direct investment in the United States, as well as U.S. direct investment in Japan, has evolved from 1999 to 2014.

**Figure 2.—U.S.-Japan Direct Investment Positions, 1999-2014  
(Historical Cost)**



Source: Department of Commerce (Bureau of Economic Analysis).

<sup>35</sup> The foreign direct investment figures reported in this section are calculated on a historical basis. Foreign direct investment in the United States is defined as the ownership by a foreign investor of 10 percent or more of a U.S. business; a similar definition applies to U.S. direct investment in Japan. In contrast, portfolio investment generally reflects short-term activity in financial markets, or ownership by a foreign investor of less than 10 percent of a U.S. business. For data on foreign direct investment, see Nathan R. Hansen, and Ricardo Limés, “Foreign Direct Investment in the United States for 2012-2014: Detailed Historical-Cost Positions and Related Financial Transactions and Income Flows,” *Survey of Current Business*, September 2015. For definitions of foreign direct investment and portfolio investment, see [https://www.bea.gov/international/pdf/bach\\_concepts\\_methods/Direct%20Investment%20Concepts.pdf](https://www.bea.gov/international/pdf/bach_concepts_methods/Direct%20Investment%20Concepts.pdf).

Table 1, below, compares the amount of Japanese direct investment in the United States with direct investment sourced from other countries. Japan was the second largest source of direct investment in the United States. Three other large sources of direct investment in the United States, by country, were the United Kingdom (\$448.5 billion), the Netherlands (\$304.8 billion), and Canada (\$261.2 billion).<sup>36</sup> By industry, the three largest targets for Japanese direct investment in the United States were wholesale trade (\$120.8 billion); manufacturing (\$115.4 billion); and finance and insurance, except depository institutions (\$44.9 billion). Income from Japanese direct investment from all industries in the United States was \$20.0 billion in 2014.

**Table 1.—Top Ten Sources of Foreign Direct Investment in United States in 2014 (Historical Cost) by Country**

United Kingdom	\$448,548
Japan	\$372,800
Netherlands	\$304,848
Canada	\$261,247
Luxembourg	\$242,862
Germany	\$224,114
Switzerland	\$224,021
France	\$223,164
Belgium	\$89,097
Spain	\$58,138

Source: Department of Commerce (Bureau of Economic Analysis).

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<sup>36</sup> *Ibid.*

Employment arising from foreign direct investment made by majority-owned U.S. affiliates of Japanese companies totaled 718,900 employees in 2012, making Japan the second largest source of this type of employment in the United States; Japan trailed the United Kingdom (962,900 employees) and was followed by Germany (620,200 employees). By industry, this employment by Japanese companies was concentrated in manufacturing (326,300 employees), wholesale trade (241,700 employees), and retail trade (241,700 employees). Total expenditures on property, plant, and equipment by majority-owned U.S. affiliates of Japanese companies were \$42.7 billion in 2012, while research expenditures were \$6.2 billion.

#### U.S. direct investment in Japan

As of 2014, U.S. direct investment in Japan totaled \$108.1 billion (historical cost). Table 2, below, compares the amount of U.S. direct investment in the Japan with U.S. direct investment in other countries. Japan was the 11th largest destination for U.S. direct investment abroad. The three countries with the largest amount of U.S. direct investment (as measured by historical cost) were the Netherlands (\$753.2 billion), United Kingdom (\$587.9 billion), and Luxembourg (\$465.2 billion). By industry, the three largest targets for U.S. direct investment in Japan were finance and insurance, except depository institutions (\$54.0 billion); manufacturing (\$22.4 billion); and wholesale trade (\$10.7 billion). Income for U.S. direct investment in Japan from all industries totaled \$10.7 billion in 2014.

**Table 2.—Top Eleven Destinations for U.S. Direct Investment in 2014  
(Historical Cost) by Country**

Netherlands	\$753,224
United Kingdom	\$587,943
Luxembourg	\$465,160
Canada	\$386,121
Ireland	\$310,598
Bermuda	\$273,792
Australia	\$180,315
Singapore	\$179,764
Switzerland	\$152,879
Germany	\$115,533
Japan	\$108,315

Source: Department of Commerce (Bureau of Economic Analysis).

## **Business activities of U.S. multinational enterprises (“MNEs”)**

U.S. MNEs conduct significant business activities through their Japanese affiliates relative to their affiliates located in other countries. Table 3, below, provides statistics on the activities of U.S. majority-owned foreign affiliates in Japan compared with U.S. majority-owned affiliates based in other countries. Total sales by U.S.-majority-owned Japanese affiliates were \$235.9 billion in 2013, ranking them sixth among affiliates in other countries.<sup>37</sup> By comparison, sales by U.K. affiliates were \$753.4 billion, followed by Canadian affiliates (\$694.8 billion) and German affiliates (\$382.9 billion).<sup>38</sup> Total employment by Japanese affiliates was 311,900 employees in 2013, ranking them eighth among affiliates based in other countries.<sup>39</sup> By comparison, Chinese affiliates employed 1.7 million people in China, followed by Mexican affiliates (1.4 million) and Canadian affiliates (1.2 million).<sup>40</sup>

**Table 3.—Activities of U.S. Majority-Owned Affiliates in Japan Compared to U.S. Majority-Owned Affiliates in Other Countries in 2013**

	<b>Japan</b>	<b>Highest</b>	<b>Second Highest</b>	<b>Third Highest</b>
Total Sales (millions)	\$235,883	Canada (\$644,514)	United Kingdom (\$643,098)	Singapore (\$405,341)
Net Income (millions)	\$12,020	Netherlands (\$141,896)	Luxembourg (\$111,468)	Ireland (\$105,245)
Capital Expenditures (millions)	\$2,967	Canada (\$33,841)	United Kingdom (\$18,598)	Australia (\$16,634)
R&D Expenditures (millions)	\$2,070	Germany (\$8,272)	United Kingdom (\$5,346)	Switzerland (\$3,735)
Employees	311,900	China (1.4 million)	United Kingdom (1.2 million)	Canada (1.1 million)

Source: Department of Commerce (Bureau of Economic Analysis) and calculations by the staff of the Joint Committee on Taxation.

<sup>37</sup> Sarah P. Scott, “Activities of U.S. Multinational Enterprises in 2013,” *Survey of Current Business*, August 2015.

<sup>38</sup> *Ibid.*

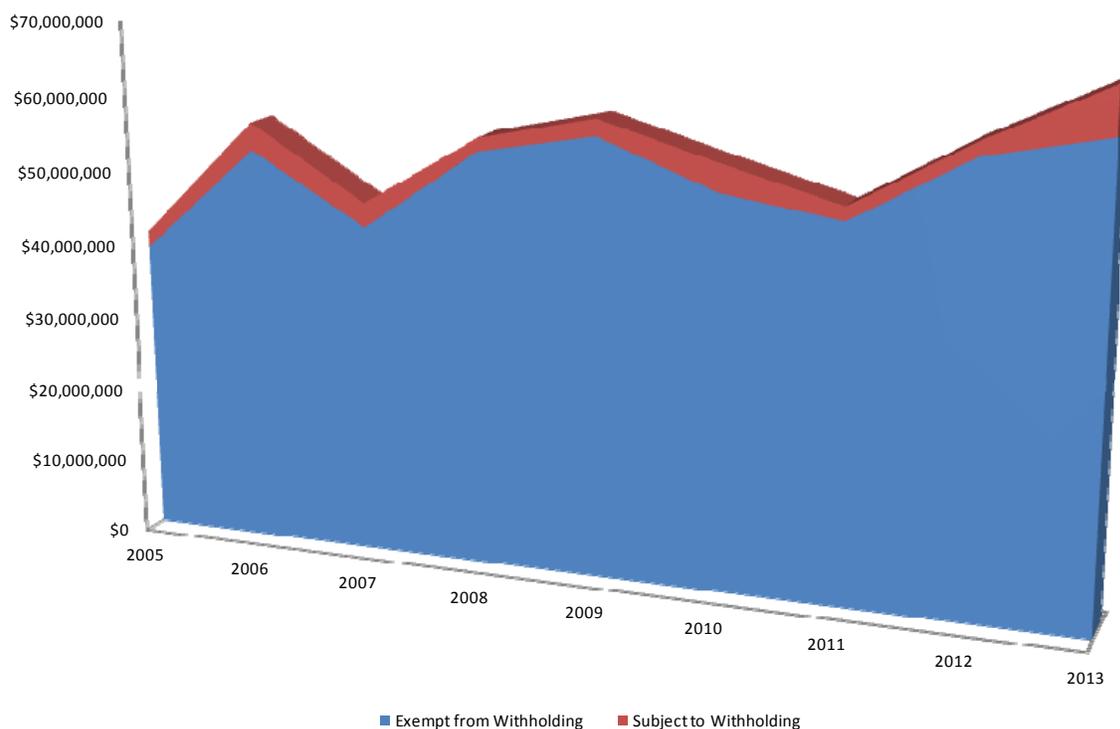
<sup>39</sup> *Ibid.*

<sup>40</sup> *Ibid.*

## Tax return data

Tax return data provide a complementary perspective on economic activity between the United States and Japan. For tax year 2013, total U.S.-source income earned by Japanese persons and potentially subject to withholding, as reported on Form 1042-S (“Foreign Person’s U.S.-Source Income Subject to Withholding”), was \$68.2 billion, with the principal types of income being interest (\$27.3 billion), dividends (\$17.2 billion), and rents and royalties (\$11.7 billion). Figure 3, below, decomposes the amount of U.S.-source income paid to Japanese persons by payments subject to withholding and payments exempt from withholding. Only a portion of U.S.-source income received by Japanese persons (\$6.3 billion) was subject to U.S. withholding tax; the amount of U.S. tax withheld was \$395.1 million.

**Figure 3.—U.S.-Source Income Received by Japanese Persons,  
2005-2013  
(Nominal Dollars)**



Source: Statistics of Income Division, Internal Revenue Service, and calculations by the staff of the Joint Committee on Taxation.

For tax year 2010, Japanese-source gross income (less losses) reported on Form 1118, which is filed by U.S. corporations claiming foreign tax credits, totaled \$44.6 billion. Slightly more than half of this income (\$23.0 billion) was categorized as other income (which includes income earned by Japanese branches of U.S. corporations). Income from rents, royalties, and license fees was \$7.8 billion, while income from dividends and interest were \$7.7 billion and

\$361.5 million, respectively.<sup>41</sup> Japanese taxes that were reported on these returns as paid, accrued, or deemed paid totaled \$6.4 billion million in 2010. Most of these taxes were eligible for the deemed-paid tax credit (\$5.3 billion). Taxes paid on rents, royalties, and license fees were \$15.9 million, while taxes paid on dividends and interest were \$30.8 million and \$8.0 million, respectively.<sup>42</sup>

Data specific to controlled foreign corporations (“CFCs”)

Table 4, below, provides data from Form 5471 (“Information Return for U.S. Persons With Respect to Certain Foreign Corporations”) and shows the number of U.S. CFCs in Japan from 2004 to 2012 and certain operating statistics of those CFCs, including end-of-year assets; current earnings and profits (less deficit) before income taxes; income taxes; dividends paid to controlling U.S. corporations; and total subpart F income earned. In 2012, there were a total of 2,381 U.S. CFCs in Japan, which collectively held \$748.4 billion in assets at the end of the year. U.S. CFCs in Japan reported current pre-tax earnings and profits (less deficit) of \$15.2 billion and total subpart F income of \$848 million. U.S. CFCs paid \$3.7 billion in dividends to their controlling U.S. corporations in 2012.

**Table 4.—Selected Statistics of U.S. CFCs in Japan, 2004-2012  
(Nominal Dollars)**

<b>Year</b>	<b>Number of CFCs</b>	<b>End-of-Year Assets (Millions)</b>	<b>Current Earnings and Profits (Less Deficit) Before Income Taxes (Millions)</b>	<b>Income Taxes (Millions)</b>	<b>Dividends Paid to Controlling U.S. Corporation (Millions)</b>	<b>Total Subpart F Income (Millions)</b>
2004	2,265	\$391,521	\$15,105	\$4,976	\$1,288	\$2,187
2006	2,554	\$473,249	\$15,746	\$5,483	\$1,616	\$1,867
2008	2,730	\$640,023	\$6,311	\$5,761	\$2,191	\$2,389
2010	2,570	\$736,684	\$19,849	\$6,853	\$4,034	\$3,299
2012	2,381	\$748,423	\$15,169	\$6,207	\$3,661	\$848

Source: Statistics of Income Division, Internal Revenue Service, and calculations by the staff of the Joint Committee on Taxation.

<sup>41</sup> The figure for gross income reported here includes income from the extraction of oil and gas as well as foreign branch income. The data is obtained from Form 1118 filings. See Scott Luttrell, “Corporate Foreign Tax Credit, 2010,” *Statistics of Income Bulletin*, Fall 2014.

<sup>42</sup> *Ibid.*

## V. EXPLANATION OF PROPOSED PROTOCOL

### **Article I**

The proposed protocol amends paragraph 5 of Article 1 of the existing treaty by deleting references to Article 20 of the existing treaty. Article 20, addressing income from teaching or research, is deleted by Article VII of the proposed protocol (described below).

### **Article II**

The proposed protocol replaces paragraph 4 of Article 4 of the existing treaty. The new paragraph 4 provides that a person, other than an individual, who is resident of both the United States and Japan (a “dual resident company”) will not be considered a resident of either the United States or Japan for purposes of claiming any benefits provided by the proposed protocol.

The Technical Explanation clarifies that a dual resident company may claim the benefits of the treaty that are not limited to residents. Additionally, a dual resident company may be treated as a resident of one country for purposes other than claiming the benefits under the proposed protocol. The Technical Explanation provides an example of a dual resident company paying a dividend to a resident of Japan. The U.S. paying agent would withhold on the dividend at the appropriate treaty rate (assuming the payee is otherwise entitled to treaty benefits) because reduced withholding is a benefit enjoyed by the resident of Japan, not by the dual resident company.

Information relating to a dual resident company can be exchanged under the proposed protocol because Article 26 is not limited to residents.

This provision of the proposed protocol differs from the rule in the U.S. Model treaty. Under the U.S. Model treaty, a dual resident company will be treated as a resident of the treaty country under the laws of which it is created or organized if it is created or organized under the laws of only one of the treaty countries. If this incorporation test does not resolve the question, then the competent authorities will attempt to determine a single state of residence. Only if the competent authorities do not reach an agreement on a single treaty country of residence will the dual resident company not be considered a resident of either treaty countries for purposes of claiming any benefits under the treaty.

### **Article III**

Article III of the proposed protocol modifies the ownership and holding period requirements of Article 10 of the existing treaty for elimination of source-country taxation of dividends beneficially owned by a treaty country company.

The existing treaty provides that dividends paid by a company that is a resident of one of the treaty countries and beneficially owned by a company that is a resident of the other treaty country may not be taxed by the country of residence of the company paying the dividends if, among other requirements, the beneficial owner of the dividends has owned, directly or indirectly through one or more residents of either treaty country, more than 50 percent of the

voting stock of the company paying the dividends for the 12-month period ending on the date on which entitlement to the dividends is determined.

The proposed protocol reduces the ownership threshold for elimination of source-country tax to at least 50 percent of the voting stock of the company paying the dividends.

The proposed protocol reduces the required holding period to the six-month period ending on the date on which entitlement to the dividends is determined.

By contrast with the existing treaty and proposed protocol, the U.S. Model treaty does not provide a zero rate of source-country withholding tax on parent-subsidiary dividends. Zero-rate provisions have, however, been included in thirteen in-force and proposed U.S. bilateral income tax treaties and protocols.<sup>43</sup> The 50-percent ownership (existing treaty (more than 50 percent) and proposed protocol (at least 50 percent)) and six-month holding period (proposed protocol) requirements of the treaty with Japan are less strict than the zero-rate requirements of the other 12 treaties. Those other 12 treaties provide 80-percent ownership and 12-month holding period requirements.

Article III of the proposed protocol also makes a conforming change to paragraph 9 of Article 10 of the existing treaty by deleting a reference in that paragraph to paragraph 2 of Article 13 of the existing treaty. Article V of the proposed protocol makes a substantive change to paragraph 2 of Article 13 (described below) that makes the Article 10 reference to this paragraph unnecessary.

#### **Article IV**

Article IV of the proposed protocol replaces Article 11 of the existing treaty, which addresses the tax treatment of interest payments arising in one treaty country (the source country) to residents of the other treaty country. While Article 11 of the existing treaty allows for source country taxation of interest beneficially owned by a resident of the other treaty country, Article IV of the proposed protocol brings the tax treatment of cross-border interest payments into closer alignment with the rules described in the U.S. Model treaty and exempts such interest from source-country taxation.

Article IV applies to interest arising in the source country that is beneficially owned by a resident of the other treaty country. The proposed protocol does not define the term “beneficial owner,” but the Technical Explanation indicates that the beneficial owner of the interest for purposes of Article 11 is the person to which the income is attributable under the laws of the source country. Special rules apply to interest earned through fiscally transparent entities for purposes of determining the beneficial owner of the interest. In particular, residence country principles control who is treated as deriving the interest, but source country rules are used to determine whether that person, or another resident of the same country, is the beneficial owner.

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<sup>43</sup> The zero-rate U.S. income tax treaties are those with Australia, Mexico, and United Kingdom (zero-rate provisions ratified in 2003); Japan and the Netherlands (2004); Sweden (2006); Belgium, Denmark, Finland, and Germany (2007); France (2009); New Zealand (2010); and Spain (protocol with zero-rate provision not yet ratified).

An example in the Technical Explanation highlights how this special rule may work in practice. In the example, FCo, a company that is a resident of Japan, owns a 50 percent interest in FP, a partnership that is organized in Japan. Japan views FP as fiscally transparent under its internal law and taxes FCo currently on its distributive share of the income of FP. Japan determines the character and source of the income received through FP in the hands of FCo as if the income were realized directly by FCo. As a result, if FP were to receive an interest payment arising in the United States, FCo is treated as deriving 50 percent of the interest received by FP under paragraph 6 of Article 4 of the existing treaty. In order to receive treaty benefits for this interest, FCo must satisfy the beneficial ownership principles of the United States with respect to the interest it derives.

The proposed protocol defines the term “interest” as interest from government securities, bonds, debentures, and any other form of indebtedness, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits. The term includes premiums attaching to such securities, bonds, or debentures. The term also includes all other income that is treated as interest under the internal law of the country in which the income arises. Interest does not include income treated as dividends under Article 10. Unlike the U.S. Model treaty, the proposed protocol does not exclude from the definition of interest penalty charges for late payment.

The reductions in source-country tax on interest under the proposed protocol do not apply if the beneficial owner of the interest carries on business through a permanent establishment in the source country and the interest paid is attributable to the permanent establishment. In such an event, the interest is taxed under Article 7 of the existing treaty. This rule includes beneficial owners that perform independent personal services through a permanent establishment because, unlike the U.S. Model treaty but like the OECD Model treaty, independent personal services are not addressed in a separate article.

The proposed protocol provides that interest is generally treated as arising in a treaty country if the payer is a resident of that country.<sup>44</sup> However, if the interest expense is borne by a permanent establishment, the interest will have as its source the country in which the permanent establishment is located, regardless of the residence of the payer. Thus, for example, if a French resident has a permanent establishment in Japan and that French resident incurs indebtedness to a U.S. person, the interest on which is borne by the Japanese permanent establishment, the interest would be treated as having its source in Japan. In the case of interest that is incurred by a U.S. branch of a Japanese resident company, the Technical Explanation indicates that the interest expense allocation rules under U.S. law determine the amount of interest expense that is treated as having been borne by the U.S. branch for purposes of this article.

The proposed protocol addresses the issue of non-arm’s length interest charges between related parties (or parties having an otherwise special relationship) by stating that this article applies only to the amount of arm’s-length interest. Any amount of interest paid in excess of the

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<sup>44</sup> This is consistent with the source rules of U.S. law, which provide as a general rule that interest income has as its source the country in which the payer is resident.

arm's-length interest is taxable in the treaty country of source at a rate not to exceed five percent of the gross amount of the excess. The treatment of excess interest under the proposed protocol differs from the U.S. Model treaty, which provides that any amount of interest paid in excess of the arm's-length interest is taxable according to the laws of each country, taking into account the other provisions of the treaty. For example, the U.S. Model treaty provides that excess interest paid to a parent corporation may be treated as a dividend under local law and, thus, entitled to the benefits of treaty provisions relating to dividends. With respect to interest paid in an amount that is less than the amount that would have been paid in the absence of the special relationship, the Technical Explanation provides that a treaty country may characterize a transaction to reflect its substance and impute interest under the authority of Article 9 of the existing treaty, which addresses transactions between affiliated entities.

The proposed protocol provides anti-abuse exceptions to source-country exemption of interest payments for two classes of interest payments. The first class is "contingent interest," defined as any interest arising in the source country that is determined with reference to the receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor or a related person, or to any other interest similar to such interest arising in the source country. As in the U.S. Model treaty but not in the existing treaty, any such interest may be taxed in the source country in accordance with its internal laws. However, if the beneficial owner is a resident of the other treaty country, the gross amount of such interest may not be taxed at a rate exceeding 10 percent. The second class of interest payment excepted from the general rule of Article IV is interest paid with respect to ownership interests in a vehicle used for the securitization of real estate mortgages or other assets, to the extent that the amount of interest paid exceeds the rate of return on comparable debt instruments as specified by the domestic law of the source country. Similar to provisions in the U.S. Model treaty and the existing treaty, any such interest may be taxed in the source country in accordance with its internal laws.

The proposed protocol provides an anti-conduit provision under which the provisions with respect to interest will not apply to interest that is paid pursuant to certain back-to-back lending arrangements. This provision is similar to anti-conduit rules dealing with dividends, royalties, and other income in the proposed protocol. In this context, 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.

## **Article V**

Article V of the proposed protocol modifies the definition of real property for purposes of application of Article 13 of the existing treaty.

The existing treaty allocates taxing rights with respect to gain on the alienation by a treaty country resident of shares of a company resident in the other treaty country and that derives at least 50 percent of its value from real estate situated within that other treaty country. Such gain may be taxed by the other treaty country, unless an exception is met with respect to

holdings of no greater than five percent of a class of shares that is traded on certain recognized stock exchanges.

The existing treaty also allocates taxing rights to the other treaty country with respect to gain on the alienation of an interest in a partnership, trust, or estate to the extent that the underlying assets consist of real property that is situated within the other treaty country.

The proposed protocol replaces paragraph 2 of Article 13 of the existing treaty, which defines the term “real property situated in the other Contracting State,” with a new paragraph 2. Subparagraph (a) of new paragraph 2, following the existing treaty, provides that such term includes a direct interest in real property. Subparagraph (b) provides that when “the other Contracting State” is Japan, the term includes shares or interests in a company, partnership or trust deriving the value of its property directly or indirectly principally from real property situated in Japan. Subparagraph (c) provides that when “the other Contracting State” is the United States, the term includes a “United States real property interest.”

By defining real property situated in the United States as including a United States real property interest, the proposed protocol is in conformity with the U.S. Model treaty, incorporating United States domestic law. Section 897(c) of the Code defines the term “United States real property interest” to include shares in a U.S. corporation that owns sufficient U.S. real property interests to satisfy an asset-ratio test on certain testing dates. The term also includes certain foreign corporations that have elected to be treated as U.S. corporations for this purpose.

According to the Technical Explanation, any distribution made by a U.S. real estate investment trust or certain U.S. regulated investment companies is taxable under paragraph 1 of Article 13 of the existing treaty (rather than under Article 10 of the existing treaty) to the extent that it is attributable to gains derived from the alienation of U.S. real property interests since the Code treats such distribution as gain recognized from the disposition of a United States real property interest.

The proposed protocol also replaces paragraph 4 of Article 13 of the existing treaty. This conforming change is made to delete a reference to paragraph 2 of Article 13 of the existing treaty that is no longer necessary because new paragraph 2 is strictly definitional.

## **Article VI**

The proposed protocol restates the Article 15 rule in the existing treaty that directors’ fees and similar payments derived by a treaty country resident in his capacity as a member of the board of directors of a company that is a resident of the other treaty country may be taxed by that other treaty country. According to the Technical Explanation, this restatement allows correction of an error in the Japanese language text of the existing treaty.

The diplomatic note describes two understandings of the treaty countries related to the rule for directors’ fees. The United States and Japan agree that if a treaty country resident does not serve as a member of a board of directors of a company, Article 15 does not apply to that individual’s remuneration regardless of the individual’s title or position. The United States and Japan also agree that if a member of the board of directors of a company has other functions with

the company – as, for example, an ordinary employee, advisor, or consultant – Article 15 does not apply to remuneration paid to that individual on account of those other functions.

### **Article VII**

Article 20 of the existing treaty describes conditions under which remuneration received by an individual resident of one treaty country from the conduct of teaching or research activities while temporarily present in the other treaty country is exempt from tax in the treaty country of residence. Article VII of the proposed protocol deletes Article 20 of the existing treaty; the U.S. Model treaty likewise has no article specifically addressed to remuneration received by teachers and researchers. For individuals who are receiving benefits under Article 20 of the existing treaty at the time the proposed protocol comes into force, paragraph 5 of Article XV of the proposed protocol ensures that they will continue to receive these benefits until such time as they would have ceased to be entitled to these benefits had the proposed protocol not entered into force.

### **Article VIII**

The proposed protocol provides one modification to the limitation on benefits provision of Article 22 of the existing treaty. The publicly traded test in the limitation on benefits article of the existing treaty allows treaty benefits for a company the shares of which are traded on a “recognized stock exchange.” In the case of Japan, the existing treaty includes “any stock exchange established under the terms of the Securities and Exchange Law (Law No. 25 of 1948) of Japan.” The proposed protocol replaces “the Securities and Exchange Law” with the currently applicable “the Financial Instruments and Exchange Law.” The Financial Instruments and Exchange Act,<sup>45</sup> promulgated on June 14, 2006, is the current name of such legislation in Japan.

### **Article IX**

Article IX of the proposed protocol replaces paragraph 1 of Article 23 of the existing treaty. The change was made to update the existing treaty to bring the treaty into conformity with Japan’s new statutory rules for providing relief from double taxation. This change reflects the recent adoption of a dividend participation exemption system in Japan.

One of the principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the treaty countries that may be taxed by the other treaty country. Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

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<sup>45</sup> The technical title of the act is “The Act for the Amendment of the Securities and Exchange Act, etc. (Act No. 65 of 2006) and the Act for the Development, etc. of Relevant Acts for Enforcement of the Act for the Amendment of the Securities and Exchange Act, etc. (2006 Act No. 66)”.

Part of the double tax problem is dealt with in other articles of the existing treaty and the proposed protocol that limit the right of a source country to tax income. This article provides further relief where both Japan and the United States otherwise still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence will waive its overriding taxing jurisdiction to the extent that this article applies.

### Internal taxation rules

#### United States

The United States taxes the worldwide income of its citizens and residents. The United States seeks to mitigate double taxation generally by allowing taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign-source income. An indirect or “deemed-paid” credit is also provided. Under this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and that receives a dividend from the foreign corporation (or an inclusion of the foreign corporation’s income) is deemed to have paid a portion of the foreign income taxes paid (or deemed paid) by the foreign corporation on its earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received.

A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit only offsets U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. The limitation is computed separately for certain categories of income (e.g., passive income and general category income) in order to prevent the crediting of foreign taxes on certain high-taxed foreign-source income against the U.S. tax on certain types of traditionally low-taxed foreign-source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

#### Japan

Japanese double tax relief is provided to domestic corporations and resident individuals through a foreign tax credit. Japanese foreign tax credits are subject to an overall limitation equal to the product of Japanese income tax multiplied by the ratio of foreign source income to taxable income. Surplus foreign taxes may be carried forward for three years. Surplus foreign tax credit limitation may also be carried forward for three years. A taxpayer may elect to deduct all foreign taxes for a taxable year in lieu of the foreign tax credit.

Under prior Japanese law, a deemed-paid credit was available for certain taxes paid by foreign subsidiaries to a Japanese parent. Under present Japanese law double taxation on dividends is generally avoided through a participation exemption system. Japanese resident companies are allowed a 95-percent exemption from corporate tax for dividends received from a foreign subsidiary (the Foreign Dividend Exclusion Rule). However, certain Japanese shareholders must report currently any undistributed profits of “designated tax haven subsidiaries.” A designated tax haven subsidiary is a foreign company in which more than 50

percent of the shares are owned directly or indirectly by Japanese residents, and which is either not subject to any income taxation in its home jurisdiction or is subject to an effective tax rate of 20 percent or less, as computed under Japan's tax accounting rules. A designated tax haven subsidiary may be fully or partially excluded from this regime if it satisfies (1) a business test; (2) a substance test; (3) an administration and control test; and (4) either an independence test or a local business test.

### Proposed protocol

The proposed protocol retains the provision that Japan will allow a foreign tax credit against Japanese tax for a Japanese resident deriving income from the United States where such income may be taxed in the United States under the provisions of the treaty. The amount of credit may not exceed the amount of the Japanese tax which is appropriate to that income. Income beneficially owned by a resident of Japan that may be taxed in the United States under the provisions of the treaty is deemed to arise from sources in the United States for purposes of computing the Japanese foreign tax credit limitation.

Additionally, under the proposed protocol, Japan will exclude from taxable income, under its 95-percent participation exemption rule, certain dividends paid by a company which is resident in the United States to a company resident in Japan. The exclusion applies where the Japanese-resident company has owned at least 10 percent of the total shares issued by the U.S.-resident company during the period of six months immediately before the day when the obligation to pay dividends is confirmed. This benefit is subject to the provisions of Japanese domestic law except for the provisions with regard to share ownership requirements.

### **Article X**

The proposed protocol makes changes to two references to Article 11 (rules for cross-border interest payments) in Article 24 (nondiscrimination rules) of the existing treaty. These nonsubstantive changes are necessary because the proposed protocol replaces the rules of Article 11 of the existing treaty with new rules for cross-border interest (also in Article 11).

The proposed protocol replaces a reference to paragraph 8 of Article 11 with a reference to paragraph 6 of Article 11. Paragraph 6 of Article 11, as rewritten by the proposed protocol, is identical to paragraph 8 of Article 11 of the existing treaty.

The proposed protocol deletes a reference to paragraph 10 of Article 11 of the existing treaty. Paragraph 10 of Article 11 of the existing treaty allows a treaty country to impose its branch interest tax under the treaty rules for cross-border interest payments, and the reference to paragraph 10 in the existing treaty provides that the nondiscrimination rules of Article 24 do not prohibit a treaty country from imposing its branch interest tax. The proposed protocol generally eliminates source-country taxation of cross-border interest payments, and it does not include the paragraph 10 rule permitting imposition of a branch interest tax. Accordingly, the reference to paragraph 10 is no longer necessary.

## Article XI

The proposed protocol expands the mutual agreement procedures available under Article 25 of the existing treaty to mandate binding arbitrations in cases in which the competent authorities are unable to reach negotiated agreement. New paragraphs 5, 6, and 7 announce the basic conditions and time frames under which a case may proceed to arbitration, define terms, establish nondisclosure rules and require that the competent authorities develop further written rules to govern mandatory arbitration cases under the treaty prior to commencement of any case under this new procedure. In partial fulfillment of the requirement to develop such rules, specific operating rules are prescribed in Article XIV of the proposed protocol as new paragraph 14 in the 2003 Protocol. A mandatory and binding arbitration procedure is a departure from the mutual agreement procedures included in the U.S. Model treaty, but is similar to provisions in the recent U.S. income tax treaties.<sup>46</sup>

Consistent with the mutual agreement procedures under the existing treaty, persons bring to the attention of the competent authorities instances in which action of one or both of the two countries results in taxation that is not in accord with the treaty. The competent authorities are authorized to clarify issues, resolve disputes and otherwise address issues of double taxation, including cases that are not explicitly provided for in the treaty. The person presenting such a matter (“the presenter”) must present the case to one of the competent authorities within three years of the first notification of the action that resulted in taxation not in accordance with the treaty. The proposed protocol includes additions to the 2003 Protocol that provide that taxation not in accordance with the treaty may result as of the date on which any of the following occurs: tax is assessed, paid or otherwise determined; official notices are issued by the tax authorities informing taxpayers of proposed adjustments or corrections to tax. The diplomatic note at paragraph 4 makes clear that the suspension of collection procedures by a tax administration is not relevant to the determination of whether that tax administration has taken action resulting in taxation not in accordance with the treaty.

### Eligibility for arbitration procedure

Prior to the initiation of any arbitration proceedings between the two countries, the competent authorities must agree in writing upon various procedures and timetables to be applicable in all arbitration proceedings. According to the Technical Explanation, the agreed upon procedures and interpretations are to be made available in the form of published guidance before the date that the first arbitration proceeding begins and are not limited to those matters specified in paragraph 7(i). Matters on which the competent authorities must agree include the date on which notice is given to the presenter of any agreement by the competent authorities that the case is unsuitable for arbitration, the deadline for obtaining the necessary confidentiality agreements, the dates and procedures for submissions to the arbitration panel, responses to such submissions, the dates and procedures for delivery of the determination by the arbitration panel, and any response by the presenter to the determination. The competent authorities may modify

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<sup>46</sup> The U.S. tax treaties that provide mandatory arbitration are those with Belgium (entered into force in 2007); Germany (entered into force in 2007); Canada (entered into force in 2008); and France (entered into force in 2009). It is also included in the proposed protocols with Spain and Switzerland.

or supplement the rules and procedures provided in the proposed protocol to the extent necessary to better implement the intent of mandatory arbitration to eliminate double taxation.

The new rules mandate resolution through arbitration of any case initiated under the mutual agreement procedure if the competent authorities have tried but are unable to reach a complete agreement and the conditions of new paragraphs 5, 6 and 7 of Article 25 are met. First, a case is ineligible for arbitration if the competent authorities have notified the presenter that the case is not suitable for determination by arbitration prior to the date on which arbitration proceedings otherwise would have begun. Second, cases in which a court or administrative body in either treaty country has rendered a decision with respect to the case are ineligible. Finally, a case is ineligible if it involves a matter for which consideration under the mutual agreement procedure was discretionary rather than mandatory.

The commencement of arbitration must comport with the conditions of paragraph 7 for determining a beginning date. Subparagraph 7(c) provides the general rule that an arbitration proceeding shall begin on the later of (1) two years after the commencement date of the mutual agreement procedure case, unless both competent authorities previously have agreed to a different date, and (2) the date upon which the conditions of paragraph 5 are met, that is, the presenter of the case requests arbitration in writing, and all concerned persons and representatives have submitted confidentiality agreements described below. The proposed protocol defines the commencement date of a case to be the earliest date on which both competent authorities have received the information necessary to undertake substantive consideration for a mutual agreement. The proposed protocol also defines the term “concerned person” to include the presenter of the case as well as any other persons whose tax liability to either treaty country may be directly affected by a mutual agreement arising from consideration of the case.

For cases that are also the subject of a request for an advanced pricing agreement, subparagraph 7(d) substitutes a period of six months after a taxing authority of either jurisdiction issues notice of intent to adjust or correct the pricing that is the subject of the pending request for the two year period described above. This expedited consideration of the proposed adjustment or correction of the pricing is available only if the competent authorities were already in receipt of the information necessary to begin substantive consideration for an agreement with respect to an advanced pricing agreement for at least two years.

#### Formation of the arbitration panel

The general rules on the formation and operation of the arbitration panel are provided in paragraph 14 of the 2003 protocol, added by Article XIV of the proposed protocol. The proposed protocol provides that the arbitration panel may adopt any procedures necessary for the conduct of its business so long as the procedures are not inconsistent with any other provisions of Article 25. It also provides for equitable sharing of all expenses of conducting an arbitration proceeding.

According to subparagraph 14(b), each competent authority may select one member, and the two members selected by the competent authorities select the third member, who cannot be a national or permanent resident of either jurisdiction and who will serve as chair of the panel.

None of the members may have prior involvement with the specific matters in arbitration. If either country fails to select one member, the other state may select a second. If the panel members selected by the competent authorities fail to select an eligible third panelist as required by rules or procedures agreed upon by the competent authorities, the panel members are dismissed and the selection process begins anew. No one who was an employee of the tax administration, the U.S. Treasury Department or the Japanese Ministry of Finance within a year prior to the beginning of the arbitration proceeding is eligible to be appointed to the panel.

### Confidentiality

Paragraph 7 of the Article details the confidentiality obligations of the competent authorities, the arbitration panel members and staff as well as the presenter and all concerned persons and those acting on their behalf. According to the proposed protocol, all material prepared in the course of or relating to an arbitration proceeding is considered information exchanged between treaty countries. Information received during the course of the arbitration proceeding from either treaty country or the arbitration panel is to be treated as treaty information subject to the nondisclosure provisions of the treaty as well as domestic law of both countries.

Confidentiality agreements are required of the presenter, concerned persons and representatives as well as arbitration panel members and staff. Those individuals may not disclose information relating to an arbitration proceeding (including the panel's determination) unless disclosure is permitted by the treaty and the domestic laws of the United States and Japan. Accordingly, the panel may disclose the determination only to the competent authorities, who inform the presenter and concerned persons. The confidentiality statements are to be provided to both countries, and include agreement to abide by and be subject to the confidentiality and nondisclosure requirements of the treaty's exchange of information article and the applicable domestic laws of each country. The statements of members of the panel will also include their acceptance of appointment. If any of those provisions conflict with domestic law, the most restrictive provision applies.

### Submissions to the arbitration panel

Each competent authority is permitted to make a submission to the arbitration panel, and to respond to any submission made by the other party, according to new subparagraphs 14(d) through 14(g) of the 2003 Protocol. The submission consists of a proposed resolution of each issue in the case and may include a supporting position paper. Both submissions and replies provided to the panel are required to be available to the other competent authority.

The proposed resolution describes the proposed disposition of the specific amounts of income, expense, or taxation at issue in the case, and must include the disposition of all issues that were resolved prior to the arbitration procedure. In addition, the competent authorities may offer alternative proposed resolutions for any issues which are contingent upon the resolution of an individual's residence, existence of a permanent establishment or other similar threshold issues. If there are multiple adjustments or similar issues, the proposed resolution may treat each adjustment separately.

Unlike the mandatory arbitration procedures in the treaties with Belgium, Canada and Germany, but similar to those in the treaty with France, new subparagraph 14(h) of the 2003 protocol permits the presenter of the case to submit a statement to the arbitration panel. The submission differs from that of the competent authorities in that it is limited to a written analysis and views, but is not a proposed resolution that can be considered by the arbitration panel. It cannot include information that was not provided to the competent authorities as part of the underlying mutual agreement procedure. According to the Technical Explanation, the presenter's statement is expected to be made available to both competent authorities in adequate time to consider the position explained.

### Determination of the Panel

The additions to the 2003 Protocol address the form and manner of determinations of the panel and the consequences of such determinations. The procedures specify conditions under which an arbitration proceeding may be terminated after it has begun. If no determination has been reached by the panel, the proceeding is terminated if the competent authorities agree to resolve the case and terminate the proceeding, the presenter withdraws the request that the competent authorities engage in the mutual agreement procedures, or a concerned person initiates legal action in either treaty country and the proceeding is not suspected in that country under domestic law. In addition, the proceeding may be terminated upon agreement of the competent authorities if a concerned person commits a willful violation of the disclosure provisions.

The determination of the arbitration panel is limited to a conclusion about the amount of income, expense, or tax reportable to the treaty countries. In its determination resolving the case, the arbitration panel must select one of the proposed resolutions submitted by the treaty countries for each issue presented to the panel. The determination may not state a rationale and is intended to have no precedential value for any other case. Unless otherwise agreed by the competent authorities, the presenter has 45 days from receipt of the panel's determination to advise the competent authority of his acceptance of the determination. Failure to respond within that time is deemed to be rejection of the determination of the arbitration panel. In addition, if the case is in litigation, any concerned person who is a party to the litigation must also advise, within the same time period, the relevant court of its acceptance of the determination of the arbitration panel as the resolution by mutual agreement and withdraw from the consideration of the court the issues resolved through the arbitration. Failure to do so is considered a rejection of the determination by the presenter. Any case in which the determination of the arbitration panel is not accepted is not eligible for further consideration under the mutual agreement procedure.

### Article XII

The proposed protocol replaces Article 26 in the existing treaty with rules governing exchange of information and administrative assistance that are substantially similar to those in the U.S. Model. The description below explains the scope and operation of the individual paragraphs. It also identifies instances in which the article varies from the U.S. Model.

The United States and Japan agree to exchange such information as is foreseeably relevant in carrying out the provisions of the proposed protocol or in carrying out the provisions

of the domestic laws of the two treaty countries concerning all taxes of any kind imposed by a treaty country. The use of the word “relevant” indicates the breadth of the scope of the exchanges, in establishing the standard for determining whether or not information may be exchanged under the proposed protocol. It conforms to the standard used in section 7602, which is the principal source of authority for U.S. information gathering and examination of records. The Technical Explanation makes clear that the language of the proposed protocol is intended to provide for exchange of information in tax matters to the widest extent possible, while clarifying that the United States and Japan are not at liberty to engage in “fishing expeditions” or otherwise to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.

Under section 7602, the IRS may request to examine any books, records or other material that “may be relevant,” as confirmed by the U.S. Supreme Court in a line of cases beginning with *United States v. Powell*. In the United States, the administrative authority of the IRS to obtain information by service of an administrative summons extends to the territories and possessions under section 7651 in the same manner as if the possession or territory were a State. Thus, even though paragraph 1(a) of Article 3 of the existing treaty provides a definition of “United States” that limits its meaning to its geographic sense for most purposes under the proposed protocol and specifically carves out its possessions and territories, information in the U.S. possessions or territories is subject to exchange of information pursuant to a proper request under the proposed protocol.

Information may be exchanged to enable each treaty country to administer its own domestic law, to the extent that taxation under that law is not contrary to the proposed protocol. The competent authority of one treaty country may request information about a transaction from the competent authority of the other treaty country even if the transaction to which the information relates is a purely domestic transaction in the requested country and information exchange about the transaction would not be undertaken to carry out the proposed protocol. As an example, similar to the rules applicable under the OECD Model treaty, if a U.S. company and a Japanese company transact with one another through a company resident in a third country that has no treaty with the United States or Japan, the U.S. and Japanese competent authorities may, to enforce their internal rules, exchange information about prices their respective resident companies paid in their transactions with the third-country company. The proposed protocol provides that exchange of information may include information relating to the assessment or enforcement of taxes of any kind. Enforcement includes the collection of, or prosecution in respect of, or the determination of appeals in relation to, taxes. Consequently, the competent authorities may exchange information about collection cases, cases under civil examination or criminal investigation, and cases being prosecuted.

Exchange of information is not restricted by paragraph 1 of Article 1 or Article 2. Accordingly, information about persons who are residents of neither Japan nor the United States may be requested and provided under this article. For example, if a third-country resident has a Japanese bank account and the IRS believes that funds in the account should have been, but have not been, reported, the U.S. competent authority may request information from Japan about the bank account. Similarly, the competent authorities may exchange information relating to a broader category of taxes beyond those otherwise covered by the proposed protocol, including, for example, U.S. estate and gift taxes, U.S. excise taxes, and Japanese value-added taxes.

Paragraph 1 also provides that the treaty country may specify the form in which information is to be provided so that such information could be used as evidence in judicial proceedings.

Under paragraph 2, any information exchanged under the proposed protocol is to be treated as confidential in the same manner as information obtained under the domestic laws of the treaty country receiving the information. Failure to comply with the conditions of confidentiality may result in suspension of further exchanges of information. According to the Technical Explanation, where a treaty country determines that the requesting treaty country does not comply with its duties regarding the confidentiality of the information exchanged under the proposed protocol, the requested treaty country may suspend assistance under this proposed protocol until such time as proper assurance is given by the requesting treaty country that those duties will indeed be respected. The discretion to enter into a memorandum of understanding may be used to implement special arrangements regarding confidentiality safeguards.

The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the administration, collection or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes specified in the proposed protocol, or the oversight of such functions. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

The proposed protocol includes protections against requiring a treaty country to take action contrary to its own laws while ensuring that such protection is not used to refuse a proper request simply because the requested country does not have an domestic tax need for the information.

Paragraph 3 of the new Article 26 specifies that a treaty country is not required to carry out administrative measures at variance with the laws and administrative practice of either treaty country, to supply information that is not obtainable under the laws or in the normal administrative practice of either treaty country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. Paragraph 3 also adds that information may not be exchanged if it is confidential or privileged information between a client and an attorney, solicitor or other admitted legal representative where such communications are produced for the purposes of seeking or providing legal advice or of use in existing or contemplated legal proceedings. This provision is consistent with the OECD Model, but differs from the U.S. Model treaty. The United States has generally been silent about whether professional privilege was overridden by language elsewhere in paragraph 3.

Paragraph 4 provides that the requested treaty country is required to exercise its administrative powers to obtain information even if it is not needed or usable in a domestic tax matter and specifies that the restrictions in paragraph 3 do not justify a refusal to exchange of information based on lack of a domestic interest. This provision makes clear that the restrictions discussed above do not permit rejection of a request based solely on its lack of relevance under domestic law of the requested country. If information requested by a treaty country is within the scope of this article, the proposed protocol provides that the requested treaty country must obtain the information in the same manner and to the same extent as if the tax of the requesting treaty country were the tax of the requested treaty country and was being imposed by that treaty

country. According to the Technical Explanation, some taxpayers have argued that subparagraph 3(a) prevents a treaty country from requesting information from a bank or fiduciary that the treaty country does not need for its own tax purposes. This paragraph clarifies that paragraph 3 does not impose such a restriction and that a treaty country is not limited to providing only the information that it already has in its own files.

The proposed protocol at paragraph 5 provides that the provision of paragraph 3 not be construed to permit a treaty country to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it related to ownership interests in a person. According to the Technical Explanation, this paragraph effectively prevents a treaty country from relying on paragraph 3 to argue that its domestic bank secrecy laws (or similar legislation relating to disclosure of financial information by financial institutions or intermediaries) override its obligation to provide information under paragraph 1. This paragraph also requires the disclosure of information regarding the beneficial owner of an interest in a person, such as the identity of a beneficial owner of bearer shares.

The Technical Explanation clarifies that subparagraphs 3(a) and (b) do not permit a treaty country to decline a request where paragraph 4 or 5 applies. Paragraph 5 includes situations in which the tax authorities' information-gathering powers with respect to information held by banks and other financial institutions are subject to different requirements than those that are generally applicable with respect to information held by persons other than banks or other financial institutions.

Paragraph 10 of the diplomatic note clarifies that the new Article 26 has effect from the date of entry into force of the proposed protocol without regard to the taxable year to which the matter relates, provided all of the conditions and requirements of the Article are satisfied. Thus, for example, a treaty country may seek information under the proposed protocol with respect to a taxable year prior to the entry into force of the proposed protocol.

### **Article XIII**

The proposed protocol replaces Article 27 of the 2003 protocol, which requires the treaty partners to attempt to collect taxes to the extent needed to ensure limitations on treaty benefits are respected. Under the new Article 27, rules governing the collection of taxes necessary to ensure that treaty benefits and limitations on such benefits are respected remain similar to the rules under the existing treaty, similar to the provisions of the U.S. Model Treaty Article 26(7). Unlike the U.S. Model treaty, however, the nature of the administrative assistance available is expanded to mutual assistance in the collection of revenue claims with respect to taxes not limited by the general scope provisions. Revenue claims may include claims for taxes, penalties, interest and related administrative expenses arising from attempts to collect, so long as the collection of such taxes would not be contrary to the treaty. The nature of the expanded mutual collection assistance is described below. Specific operating rules are prescribed in Article XIV of the proposed protocol as new paragraph 15 in the 2003 Protocol.

### Scope of taxes subject to mutual collection assistance

The taxes that may be the subject of a request for collection assistance are not limited by the general scope provisions of Article 1 and 2. In addition to the taxes covered by the existing treaty under Article 2, both Japan and the United States have identified additional taxes that are eligible for collection assistance. In paragraphs 6 through 9 of the diplomatic note amending the notes exchanged in 2003, the negotiators' understanding of what additional taxes may be covered are set forth as follows. For Japan, the additional taxes that are eligible for collection assistance are the inheritance and gift taxes, as well as the consumption tax that is imposed at the national level. For the United States, the additional taxes that are eligible for mutual collection assistance are the following taxes: Federal estate and gift taxes; insurance excise taxes on foreign insurers under sections 4371 through 4374; excise taxes imposed with respect to private foundations under sections 4940 through 4948; and employment and self-employment taxes imposed pursuant to Chapters 2, 21, 22, 23 and 23A of the Code.

### Limitations on persons whose debts are subject to mutual collection assistance

Mutual assistance for collection is available with respect to taxes owed by legal entities or companies, as well as individuals. With respect to legal entities, it is intended that mutual agreement procedures of Article 25 be first exhausted. Accordingly, collection assistance is available only if the revenue claim is of a type that is ineligible for determination under the mutual agreement procedures, has been finally determined under such procedures, or was the subject of an Article 25 procedure that the taxpayer has terminated.

With respect to individuals, the availability of mutual collection assistance varies depending on whether the individual is a national, as defined in Article 3 of the existing treaty, of the country that is being asked to provide assistance. Under Article 3(j)(i), a national of Japan is defined as an individual "possessing the nationality of Japan." For the United States, a national is a citizen. A country may request assistance in collection from its own nationals, as well as citizens or residents of third countries. However, a country cannot compel the other country to assist collection against its own nationals except in those cases in which the individual filed a fraudulent tax return or refund claim, willfully failed to file a tax return, or transferred assets to his home country in order to avoid collection.

### Process applicable to mutual collection assistance

Prior to implementation of the new form of mutual assistance, the competent authorities are required to consult and agree upon its mode of application. The resulting agreement is required to include limitations on the number of times that either jurisdiction may apply for such assistance within a calendar year, minimum monetary amounts for the revenue claims that are the subject of the applications for assistance, and a process for remitting any amounts collected under this provision of the treaty. Taken together, these terms and conditions promote reciprocity and minimize administrative burden. If either competent authority later determines that there is an imbalance of levels of assistance, assistance may be suspended and consultations renewed to agree upon new limitations, under new paragraph 15 of the 2003 Protocol.

The new Article 27 establishes standards that a request for assistance must meet in order to be honored. The revenue claim in question must be finally determined under domestic law of the requesting state, and be certified to that effect by the competent authority. A claim is finally determined only if administrative and judicial rights to dispute the underlying claim have lapsed or been exhausted, such that the requesting state could collect under its domestic law. The standard for evaluating whether or not a revenue claim is finally determined is established in new paragraph 15 to the 2003 Protocol. Under the standard therein, specific post-collection rights are disregarded for purposes of determining whether or not the predicate for an application for assistance is met. The right to seek a refund of tax in either administrative or judicial proceedings is not taken into account in determining whether a revenue claim of the United States is finally determined. With respect to a Japanese revenue claim, the right to pursue a legal action under the Administrative Case Litigation Act, Article 36 (Law No. 139 of 1962) does not preclude treating the claim as having been finally determined.

No obligation is imposed to accept a request for assistance if the administrative burdens in doing so would be substantially disproportionate to the benefit to the country in which the revenue claim arose. Collection assistance is also not required if the claimant has not pursued appropriate collection measures under its domestic law. Finally, in no circumstances is either jurisdiction expected or required to take action that is contrary to its domestic law or public policy.

#### Effect of accepting application for mutual collection assistance

Upon entry into force of the proposed protocol, the competent authorities may accept any revenue claim that satisfies the conditions, without regard to the taxable year to which the claim relates or the date on which the claim was finally determined. Acceptance of an application for mutual collection assistance of a revenue claim generally requires that the revenue claim be treated as if it arose in the jurisdiction providing assistance. The competent authority is obligated to render assistance by making reasonable efforts to collect the revenue claim.

The accepted revenue claim is not accorded priorities to which domestic claims would be entitled nor is it limited by the limitations periods applicable to domestic revenue claims of the assisting jurisdiction. Instead, the limitations period is controlled by the law of the jurisdiction in which the claim arose, but that period may be suspended or interrupted if actions taken to assist with collection are of a type that would have suspended or interrupted the running of a limitations period in the original jurisdiction. For example, if Japan accepted a revenue claim of the United States and its efforts to collect resulted in taxpayer assets in the custody of a court, such action would suspend the limitations period both in the United States and in Japan, because court custody of assets subject to tax collection results in a suspension of the limitations period for collection under Code section 6503(b). Similarly, if the limitations period for collection under Code section 6502 elapses in the United States, the United States must notify Japan, which must immediately cease its collection efforts.

No new rights to seek administrative or judicial review are provided. In addition, the taxpayer may not challenge the merits of the tax liability underlying the revenue claim, or the competent authority certification that the tax was finally determined. However, to the extent that there are rights to challenge the appropriateness of domestic collection action, such rights are

available to resist collection undertaken to satisfy the revenue claim. Thus, the taxpayer whose Japanese revenue claim with respect to which the United States agrees to provide collection assistance cannot challenge the certification by the Japanese competent authority that there is a tax due, nor can the taxpayer seek review of the acceptance by the U.S. competent authority regarding whether the treaty conditions for assistance were met. However, in providing the assistance, the United States must comply with domestic law restrictions on the types of collection action permitted, including taxpayer rights to notice, safeguards against improper collection, exemption from levy for certain types of property, and other collection rights measures under the Code. With respect to foreign revenue claims for which the IRS provides collection assistance pursuant to a tax treaty obligation, the current practice of the IRS is to allow access to collection appeals right, but not collection due process rights.

#### **Article XIV**

The proposed protocol includes an article that amends the 2003 protocol in four ways.

First, it amends subparagraphs (1)(a) and (1)(b) of the 2003 protocol to change the references to “United States excise tax” to “Federal excise tax,” thus clarifying that the excise taxes in question are national rather than state or local taxes.

Second, it deletes paragraph 9 of the 2003 protocol. That paragraph provided a rule treating distributions by REITS that are attributable to gains derived from alienation of real property as capital gains taxable under Article 13. The paragraph is moot due to the changes to Article 13 made by Article V of the proposed protocol, as explained in the description of Article V, above.

Third, new paragraph 14 provides details of the intended implementation of the revised mutual agreement procedures under Article 25 as amended by Article XI of the proposed protocol and explained in the description of Article XI, above.

Fourth, new paragraph 15 provides details of the intended implementation of the new collection procedures under Article 27 as amended by Article XIII of the proposed protocol and explained in the description of Article XIII, above.

#### **Article XV**

Article XV provides that the proposed protocol is subject to ratification in accordance with the applicable procedures of each country, and that instruments of ratification will be exchanged as soon as possible. The proposed protocol will enter into force upon the exchange of instruments of ratification.

The proposed protocol is effective with respect to taxes withheld at source for amounts paid or credited on or after the first day of the third month next following the date on which the proposed protocol enters into force. The Technical Explanation provides an example. Assuming instruments of ratification are exchanged on April 25 of a given year, the withholding rates specified in new Article 11 of the proposed protocol would be applicable to any interest paid or crediting on or after July 1 of that year. With respect to other taxes, the proposed protocol is

effective for taxable years beginning on or after January 1 of the year following the date on which the proposed protocol enters into force.

The mandatory binding arbitration rules provided in new paragraphs 5, 6, and 7 of Article 25 as amended by Article XI of the proposed protocol will have effect with respect to cases that are under consideration by the competent authorities as of the date on which the proposed protocol enters into force. For such cases, the commencement date is the date on which the proposed protocol enters into force. For cases that come under consideration by the competent authorities after the date on which the proposed protocol enters into force, the binding arbitration rules apply. The Technical Explanation makes it clear that the binding arbitration rules may apply with respect to tax liabilities (or potential tax liabilities) arising before the proposed protocol enters into force. Additionally, cases that are open and unresolved as of the entry into force of the proposed protocol will go into binding arbitration on the later of two years after the entry into force of the proposed protocol (unless both competent authorities have previously agreed to a different date) and the earliest date upon which all the agreements required by new subparagraph 7(c) of Article 25 have been received by both competent authorities.

The exchange of information and mutual assistance rules provided in Article 26 and Article 27 as amended by Articles XII and XIII of the proposed protocol will have effect from the date of entry into force of the proposed protocol. Paragraph 10 of the diplomatic note clarifies these articles have effect without regard to the taxable year to which the matter or revenue claim related, provided that all of the conditions and requirements of the respective articles are satisfied.

A person who is entitled to the benefits of Article 20 of the 2003 treaty (relating to teachers and researchers) at the time of the entry into force of the proposed protocol will be entitled to such benefits until such time as the individual would have ceased to be entitled to such benefits if the proposed protocol had not entered into force.

The proposed protocol will remain in effect as long as the 2003 treaty remains in force.

## VI. U.S. MODEL TREATY AS A REFLECTION OF U.S. TAX POLICY

The most recent U.S. Model treaty was published in 2006. A number of U.S. income tax treaties and protocols to earlier treaties have entered into force since then. Significant deviations from the U.S. Model treaty have, understandably, proliferated. This proliferation can be expected to continue as the U.S. State Department and Treasury Department negotiate new income tax treaties and protocols. Earlier this year, the Treasury Department proposed several revisions and additions to the U.S. Model, and announced its goal of completing its revision of the U.S. Model treaty this year.<sup>47</sup>

The proposed protocol includes two provisions, the mandatory binding arbitration rules and the mutual collection assistance provisions, that diverge from the U.S. Model treaty and are not addressed in the proposed revisions to the U.S. Model treaty that have thus far been made public. The Committee may wish to consider, among other questions described below, the extent to which these deviations represent actual U.S. income tax treaty policy notwithstanding that they differ from the policy as provided in the U.S. Model treaty. The Committee also may wish to inquire when the Treasury Department expects to publish the new model treaty and whether that new model will include provisions similar to the deviations described below.

### A. Mandatory Arbitration

Although tax treaties traditionally have not included a mechanism to ensure resolution of disputes, the addition of mandatory procedures for binding arbitration as part of the mutual agreement procedures has become increasingly frequent in recent years. Four U.S. tax treaties currently in effect include such provisions. Mandatory binding arbitration is provided upon request of the taxpayer in paragraph 5 of Article 25 (Mutual Agreement Procedure) of the OECD Model treaty. Following its two-year study on base erosion and profit shifting, the OECD concluded that the inclusion of mandatory binding arbitration is necessary to achieve the goal of the mutual agreement procedures, which generally encourage, but do not require, dispute resolution by the competent authorities.<sup>48</sup>

Proponents of mandatory arbitration believe that incorporating into the mutual agreement process a mechanism that would ensure the resolution of disputes would prompt the competent authorities to reach mutual agreement earlier, so as to avoid any arbitration proceedings. As a result, these proponents hold the view that cases will be resolved more promptly and on more appropriate bases through the mutual agreement procedure than previously, although actual arbitration may be rare. In considering the proposed protocol, the Committee may wish to consider the extent to which the inclusion of mandatory arbitration rules and the particular features of the arbitration provisions in the proposed protocol now represent the United States policy regarding mandatory binding arbitration. In particular, the Committee may wish to

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<sup>47</sup> Full text of the proposed rules published on May 20, 2015, at the Resource Center, Department of Treasury, available at <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/international.aspx>.

<sup>48</sup> OECD, *Making Dispute Resolution Mechanisms More Effective, Action 14-2015 Final Report*, OECD/G20 Base Erosion and Profit-Shifting Project, OECD Publishing, Paris.

inquire about the criteria on which the Treasury Department determines whether to include such provisions in a particular treaty, the appropriate scope of issues eligible for determination by binding arbitration, the absence of precedential value of arbitration determinations, the role of the taxpayer in an arbitration proceeding and how to ensure adequate oversight of the use of mandatory arbitration.

### **Criteria for inclusion of mandatory binding arbitration in a particular treaty**

The Committee may wish to ask whether the Treasury Department intends to seek inclusion of mandatory arbitration provisions in future U.S. income tax treaties and protocols. If Treasury does not so intend, the Committee may wish to inquire about the basis on which the Treasury Department determines whether a particular treaty should include mandatory and binding arbitration. The absence of a mandatory arbitration provision in the pending treaties with Hungary, Chile, and Poland, contemporaneous with the inclusion of such a provision in the proposed protocol and the pending protocols with Spain and Switzerland suggests that the inclusion is not yet standard.

Mandatory arbitration provisions are found in the 2009 protocol to the United States-France treaty, which entered into force in December 2009, the United States-Belgium treaty, which entered into force at the end of 2007, the protocol to the United States-Germany treaty, which entered into force at the end of 2007, and the protocol to the United States-Canada treaty, which entered into force at the end of 2008. The staff of the Joint Committee on Taxation has provided detailed analyses of those arbitration provisions,<sup>49</sup> including the “last best offer” or “final offer” arbitration methodology adopted in the treaty with Belgium and the protocols with Germany and Canada.<sup>50</sup> Those analyses also include descriptions of mandatory arbitration procedures adopted in the OECD Model treaty and by the European Union.

Regardless of whether the Treasury Department expects mandatory arbitration to become a standard feature in all future U.S. tax treaties, the Committee may wish to inquire whether the Treasury Department intends to develop and publish a standardized set of arbitration principles and procedures for inclusion in a revision to the U.S. Model treaty.

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<sup>49</sup> See Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and France* (JCX-49-09), November 6, 2009; Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Belgium* (JCX-45-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany* (JCX-47-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada* (JCX-57-08), July 8, 2008.

<sup>50</sup> In “last best offer” or “final offer” arbitration, each of the parties proposes one and only one figure for settlement, and the arbitrator must select one of those figures as the award. The methodology is intended to encourage the competent authorities not to assert unreasonable claims. In the United States, this arbitration methodology is also informally known as “baseball arbitration” because it is similar to the procedure used to resolve Major League Baseball salary disputes under the prevailing collective bargaining agreement. In the proposed protocol, the competent authorities are permitted to provide alternative proposed resolutions if there are issues, the resolution of which, is contingent on the outcome of the other issues.

## Scope

The scope of cases with respect to which mandatory arbitration is available has varied among the protocols and treaties entered into force to date, and in the case of the proposed protocol, varies from the U.S. Model treaty general rule that a taxpayer must have filed returns with both jurisdictions in order to be eligible to invoke the mutual agreement procedures. The scope of cases eligible for binding arbitration in the treaties that have entered into force varies greatly, though all grant discretion to the competent authorities to determine that a case is not suitable for arbitration.<sup>51</sup> Questions about the cases that are appropriately eligible for mandatory arbitration include questions about the subject matter as well as the procedural posture of the case.

With respect to the appropriate procedural posture of a case for arbitration, the proposed protocol with Japan differs from other recent proposals in that it permits a case to proceed to mandatory arbitration even if litigation has commenced in one of the jurisdictions, unless a court has already decided the issue to be arbitrated. In contrast, the pending protocol with Spain precludes arbitration in cases in litigation. Under the rule of the proposed protocol with Japan, there may be a risk of duplicative use of resources, i.e., that of the court and the arbitration panel, as well as risk of possible disputes about the implementation of an arbitration determination consistent with the procedures required by the court to resolve the matter before it. In the United States, a proceeding in the United States Tax Court generally may not be ended without a resolution on the merits. Presumably, it is intended that the Court may be informed of the determination of the arbitration panel in sufficient detail to reflect the determination in a decision to be filed with the Court.

Another instance in which the procedural posture of a case varies from other recently negotiated arbitration provisions is the treatment of cases involving an application for a bilateral advanced pricing agreement (“APA”) to preempt transfer pricing disputes for years for which tax returns are not yet due, or have not been filed, in one of the treaty jurisdictions. The negotiation of an APA is undertaken as part of the mutual agreement procedures. The extent to which the presenter may be credited with the time during which an application for an APA was pending as time that satisfies the time requirements for commencing an arbitration procedure is not uniform among the various treaties with mandatory arbitration provisions. Neither the United States-France protocol nor the pending protocol with Spain includes an agreement to an expedited schedule similar to that in the proposed protocol. The United States has agreed with Japan that arbitration may commence on the later of the date that is six months after issuance of a notice to adjust or correct the pricing that is subject of the request for an APA, or the date on which the

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<sup>51</sup> The protocols to the U.S.-Germany treaty and U.S.-Canada treaty mandate arbitration if a case involves the application of one or more of the following articles of the treaty (and is not a particular case that the competent authorities agree is not suitable for determination by arbitration): Article 4 (Residence), but only to the extent the case relates to the residence of natural persons; Article 5 (Permanent Establishment); Article 7 (Business Profits); Article 9 (Related Persons), and Article 12 (Royalties), but only to the extent the case relates (1) to the application of Article 12 to transactions involving related persons or (2) to an allocation of amounts between taxable and nontaxable royalties. In contrast, cases under either the U.S.-France treaty or U.S.-Belgium treaty may be resolved through arbitration in any case involving the application of any article of the treaty.

formal request for arbitration and all necessary confidentiality statements of concerned persons are provided to the competent authorities.

The Committee may also wish to inquire as to the U.S. negotiating position with respect to the appropriate subject matter of cases eligible for mandatory arbitration. In particular, the Committee may wish to consider whether mandatory arbitration should be available for all articles under a treaty or only for articles that have given rise to cases that historically have been difficult to resolve under the mutual agreement procedure and the factors the competent authorities are expected to take into account in deciding that a particular case is or is not suitable for arbitration. Although granting broad discretion to the competent authorities in making such a decision may facilitate agreements in individual cases, the lack of explicit factors for deciding which cases may go to arbitration may create unpredictability for taxpayers and undermine the efficacy of the mandatory arbitration procedure. The Committee may also wish to inquire as to the Treasury Department's preferred approach and the circumstances in which the Treasury Department is willing to deviate from that approach.

### **Absence of reasoned opinion and precedential value**

Under the proposed protocol, the arbitration panel must limit its determination to stating an amount of income, expense, or tax reportable to the competent authorities. In addition, under the proposed protocol, like the treaties with France, Belgium and Canada, the determination will not state a rationale and will not be accorded precedential value. The Committee may wish to inquire whether the lack of a stated rationale for the determination of an arbitration panel is consistent with appropriate standards of transparency and accountability of tax administration.

The absence of transparency in the rationale underlying a determination can contribute to possible competitive disparities among persons representing taxpayers or working for alternative dispute resolution firms. To the extent that the persons qualified to be appointed to arbitration panels may serve on multiple cases or are involved in the handling of cases on behalf of clients who present cases to the competent authorities of various jurisdictions, those persons and firms can amass a body of knowledge with respect to the negotiating positions taken by competent authorities that is unavailable to others, providing a competitive edge for their clients and posing a barrier for other representatives to develop the necessary expertise. Such disparities could result without any inappropriate behavior by any of the concerned persons, representatives, or arbiters.

### **Taxpayer participation**

Under the proposed protocol, the presenter is entitled to submit a written statement of his or her analysis and views of the case to the arbitration panel, but not a proposed resolution. The Committee may wish to consider whether U.S. tax treaties should explicitly provide an opportunity for the presenter of the case to provide a submission directly to the competent authorities in all cases under the mutual agreement procedures, and not only in mandatory arbitration proceedings. The U.S. Model treaty does not provide the presenter of a case an explicit opportunity to participate in a case that is being resolved under the standard mutual agreement procedure, although published guidance on applicable procedures suggests that presentations by taxpayers, including presentations to both competent authorities, are permitted

at the discretion of the competent authorities.<sup>52</sup> Instead, the taxpayer's participation is generally limited to presenting its case to the competent authority to which the taxpayer initially presented the case, after which the competent authority may or may not relay the substance of the taxpayer's views during negotiations with the other competent authority. The substantive negotiations are conducted country-to-country by the competent authorities. The Committee may wish to inquire about the extent to which the opportunity for the presenter of the case to submit written analysis and views directly to an arbitration panel is a substantive difference in the level of participation available to the presenter under the standard mutual agreement procedure.

### **Required Treasury report on mandatory arbitration**

As a condition of ratifying the recently considered protocol with Switzerland, the Committee commented on the proposed mandatory arbitration and recommended extending the existing reporting requirements included in the resolution of advice and consent to ratification of the 2009 protocol to the treaty with France to the Swiss protocol.<sup>53</sup> Specifically, the condition requires a two-part report. First, within two years after the protocol enters into force, and before the first arbitration conducted pursuant to the mandatory arbitration procedure, the Treasury Department must submit the text of the rules of procedure applicable to arbitration panels, including conflict of interest rules to be applied to members of the arbitration panel, to the Senate Committees on Finance and Foreign Relations and the Joint Committee on Taxation. As part of the implementation of the arbitration provisions in the treaties with Belgium, Germany, France and Canada, the competent authorities have entered into memoranda of understanding, and published procedures that are to be followed.<sup>54</sup>

The second part of the report requires specific data on the arbitrations conducted. To date, no such report has been received. This portion of the report is required to be submitted by the Treasury Department to the Joint Committee on Taxation and the Senate Committee on Finance within 60 days after a determination is reached in the 10th arbitration proceeding conducted pursuant to any of the treaties that require binding arbitration, and be submitted annually for five years following the first year in which it is submitted. The Committee may wish to consider expanding the scope of the required Treasury Report to include information with respect to the arbitration procedure of the proposed protocol. The Committee may also wish to consider whether to require interim reports regarding the number of completed arbitration proceedings.

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<sup>52</sup> Rev. Proc. 2015-40, section 2(2).

<sup>53</sup> See, Senate Committee on Foreign Relations Report to accompany Protocol Amending Tax Convention with Switzerland, S. Exec. Report 113-7, April 29, 2014, pp. 5-8.

<sup>54</sup> The IRS has published the memoranda of understanding, the arbitration board operating guidelines, and other relevant agreements reached with each of the competent authorities on its website, available at <https://www.irs.gov/Businesses/International-Businesses/Mandatory-Arbitration-with-Germany,-Belgium-and-Canada>.

## **B. Mutual Collection Assistance Under Present Law**

The proposed protocol with Japan departs from the U.S. Model Article 26 (Exchange of Information and Administrative Assistance) in providing for assistance in the collection of revenue claims of the other contracting state beyond those amounts required to ensure that treaty benefits are respected and limited to those entitled to them under the terms of the treaty. As explained below, the Committee may wish to explore the basis for agreeing to this departure from general U.S. policy. The nature of safeguards protecting the rights of persons whose U.S. tax debts may be subject to collection in Japan and the extent to which persons with Japanese tax debts can be assumed to have had adequate opportunities for review of the merits of the underlying claim may also warrant inquiry.

### **Extent of collection assistance by and for the United States under present law**

Presently, the United States is a party to more than 60 income tax conventions, more than 20 tax information exchange agreements (“TIEAs”), and more than 50 Mutual Legal Assistance Treaties (“MLATs”).<sup>55</sup> In this network of agreements, exchange of information is the principal form of assistance that the United States has been willing to provide. There are three forms of administrative assistance that may be available under one of the tax treaties to which the United States is a party: exchange of information related to tax matters; collection or recovery of taxes; and service of documents. All comprehensive tax treaties include exchange of information provisions; only five include mutual assistance in collection comparable in scope to the assistance contemplated in the proposed protocol. Others authorize the more limited collection assistance similar to that found in the existing treaty and consistent with Article 26 of the U.S. Model treaty.

When the U.S. Competent Authority accepts a revenue claim from one of the countries with which it has an agreement to provide mutual collection assistance similar to that provided in the proposed protocol, it does so under its Mutual Assistance Collection Program.<sup>56</sup> At present, the United States has such agreements in force with five jurisdictions: Canada; Denmark; France; Netherlands; and Sweden. Collection assistance has long been included in the agreements with France, Netherlands and Sweden, but was generally applied only to measures necessary to ensure that availability of treaty benefits was limited to the intended persons. That limitation was in part based on concerns expressed by the Senate in considering those early agreements.<sup>57</sup>

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<sup>55</sup> See, Appendices IV, V and VI of Government Accountability Office, *Tax Administration: IRS’s Information Exchanges with Other Countries Could be Improved through Better Performance Information*, GAO-11-730, September 2011.

<sup>56</sup> See I.R.M. Par. 5.1.8.7.7 et seq. (incoming requests for assistance), par. 5.1.12.25 (outgoing requests for mutual collection assistance), and par.11.3.25.5 (disclosure to treaty partners in mutual collection assistance cases).

<sup>57</sup> See, for example, the testimony of L.N. Woodworth, former Chief of Staff of Joint Committee on Taxation, in response to Senator Fulbright questions on the operation of the collection provisions in the U.S.-France treaty, dating to Article 8 of the treaty signed in 1946. Transcript of the Executive Session of the Senate Foreign Relations Committee, 90<sup>th</sup> Congress, 2d Sess., May 27, 1968, S. Prt. at pages 657-658.

The relative infrequency of such provisions is consistent with the revenue rule doctrine, which can be traced to the centuries-long tradition based on Lord Mansfield’s statement, “For no country ever takes notice of the revenue laws of another.”<sup>58</sup> Although its vitality and scope have been questioned, most recently in *Pasquantino v. United States*,<sup>59</sup> the doctrine remains a cornerstone of all common law jurisdictions, as well as many others. In determining whether to honor a judgment of a foreign court, U.S. courts generally do not accord comity to tax or penal judgments of a foreign court.<sup>60</sup>

To the extent that countries have provided administrative assistance of any sort, including exchange of information, it has generally been a result of negotiations between or among sovereign nations, resulting in bilateral or multilateral international agreements or treaties, ensuring that any waiver of the principle will be reciprocated. In the view of some commentators, the use of such agreements should be encouraged.<sup>61</sup> Other commentary has suggested that the rule facilitates tax evasion.<sup>62</sup> Critics do not contend that the rule should be abrogated unilaterally rather than doing so via bilateral or multilateral agreement that ensures reciprocity and limits the resulting administrative burdens. A unilateral abrogation would risk great administrative burden, with little assurance of reciprocal assistance. Lack of any agreement to provide administrative assistance may result in burdening courts with requests to honor foreign judgments, requiring evaluation of foreign laws in question in order to determine whether to accord comity to the foreign judgment.

Although the United States has entered into several bilateral agreements providing for mutual assistance in collection, the United States has not agreed to the provisions for mutual assistance in collection in the proposed Protocol amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (“OECD Multilateral”), which is also pending with the Committee. In the instrument of ratification, the United States reserved the right not to provide (1) assistance for taxes imposed by possessions, political subdivisions, or local authorities of other parties to the convention; (2) tax collection assistance; or (3) assistance in serving documents (except the service of documents by mail). The reservations are reciprocal; to the same extent that the United States will not provide assistance, other parties need not assist the

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<sup>58</sup> *Holman v. Johnson*, 98 The English Reporter 1120 (King’s Bench 1775), cited in *AG of Canada v. R.J. Reynolds Tobacco Holdings, Inc.*, 268 F.3d 103, *cert. denied*, 537 U.S. 1000 (2002).

<sup>59</sup> 544 U.S. 349; 125 S. Ct. 1766; 161 L. Ed. 2d 619 (2005).

<sup>60</sup> *Restatement (Third) of the Foreign Relations Law of the United States*, secs. 483 (1987), stating “Courts in the United States are not required to recognize or to enforce judgments for the collection of taxes, fines, or penalties rendered by the courts of other states.” The principle is permissive, not a requirement.

<sup>61</sup> Mallinak, Brenda, “The Revenue Rule: A Common Law Doctrine for the Twenty-first Century,” 16 *Duke Journal of Comparative & International Law* 79. The author concludes that treaties are under-utilized as a mechanism to achieve tax collection and resolve other cross-border disputes.

<sup>62</sup> Kovatch, William J., “Recognizing Foreign Tax Judgments: An Argument for the Revocation of the Revenue Rule,” 22 *Houston Journal of International Law* 265 (Winter 2000).

United States. Thus, only the provisions relating to information exchanges and service of documents by mail are in effect for the United States.<sup>63</sup>

### **Criteria for inclusion of mutual collection assistance in a particular treaty**

Given the historic reluctance of both the executive and legislative branches to entertain abrogation of the revenue rule, the Committee may wish to inquire about the basis on which the Administration agreed to the new Article 27, with emphasis on the extent to which taxpayers' rights are protected. At the outset, the Committee may wish to inquire about the extent to which such provisions may be included in a future U.S. Model treaty. Separate concerns arise depending on whether the issue is an incoming request for assistance by Japan with respect to a Japanese tax, or an outgoing request in which the United States seeks the assistance of Japan to enforce collection of a U.S. revenue claim. With respect to both incoming and outgoing requests for assistance, the Committee may wish to inquire about the extent to which there are adequate administrative safeguards available in Japan to conclude that standards are comparable to the taxpayer rights available under the Code. In addition, inquiry about the anticipated volume of cases and administrative burden may be warranted.

With respect to determining whether requests from Japan for assistance should be entertained, the Committee may wish to inquire about the extent to which Treasury has a basis for confidence that the revenue claims of Japan were determined in a procedure that accorded the taxpayer appropriate rights to administrative or judicial review. For those cases in which a revenue claim is based on a debt of a U.S. citizen who has committed tax fraud or transferred assets to avoid collection, the Committee may wish to inquire whether the standards applicable to that determination are those of the applicant or of the assisting jurisdiction. If the standards of the applicant control, the Committee may wish to inquire how the competent authorities will determine whether a revenue claim is well-founded and should be accepted.

The Committee may also wish to ask what is intended to be the relevant time for determining citizenship in cases in which the citizenship differs between the taxable period to which the revenue claim relates and the time that a request for assistance is made with respect to a revenue claim. For example, if a Japanese national who has a tax debt in Japan subsequently emigrates and becomes a U.S. citizen, the applicable standard under which Japan may request collection assistance will depend upon whether citizenship at the time the debt arose is determinative, rather than any later point in time. If citizenship when the debt arose controls, a more lenient standard applies, while conversely, citizenship at the time the application is being considered would require that the Japanese request establish fraudulent conduct of the taxpayer. Because taxpayers cannot question the merits of the underlying claim in the treaty country providing the collection assistance under the terms of the treaty, understanding the basis of a certification of a revenue claim and how the constraints on accepting revenue claims will be interpreted is desirable.

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<sup>63</sup> Such reservations are expressly contemplated by the convention under Article 30. They can be made upon signing, upon depositing instruments of ratification, or at any later time. Reservations previously made may be added to or withdrawn. The United States did not enter any reservations to the convention upon signing.

With respect to the circumstances under which the United States will request collection assistance from Japan, the Committee may wish to inquire about the types of assets that may be exempted from collection in Japan, the nature of administrative protections against premature or improper collection measures, and whether there are protections similar in nature to those accorded to U.S. taxpayers under the Code.