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New year, new tax treaty...

On 2 February this year, the UK and Japan signed a new double tax treaty to replace the existing treaty signed in 1969. The treaty provisions came into force on 12 October, meaning that the new treaty rates in relation to tax withholding will apply from 1 January 2007.

Since Japan signed a new treaty with the US in 2003 its policy towards double taxation treaties has shifted. Many commentators now consider the Japan-US treaty to be the model which Japan hopes to secure with all its major trading partners.

This article is intended to provide a brief overview of the new treaty specifically highlighting areas in which it differs from the old treaty. In the main, the majority of changes provide for a reduction in withholding taxes for residents of the UK and Japan.

The main changes for each type of income are summarised below.

Article 10 - Dividends

Under the new treaty the withholding tax rate on dividends will be reduced from 10% to 0% for companies holding at least 50% of the voting power of a company where the shares have been held for six months (although this will not allow a reclaim of the notional 10% tax credit on UK dividends). The 0% rate will also apply to pension funds. A 5% rate will be available for companies holding at least 10% of voting power for six months.

Any resident of either country not falling into those categories will benefit from 10% withholding under the new treaty compared to 15% in the previous treaty.

Article 11 - Interest

Under the existing treaty, every resident of the UK or Japan in receipt of interest from the other state was subject to 10% withholding tax. This will be reduced to 0% for the following institutions; banks, insurance companies, pension funds or pension schemes, securities dealers and government agencies. Everyone else will continue to operate under the 10% regime.



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Article 12 - Royalties

Under the new treaty, there will be no withholding tax at source on royalties flowing between the two states. This compares to 10% under the old treaty. It should be noted however, that if the royalty exceeds an arm's length rate the treaty benefit does not apply to the excess which would be taxed at source in the country of origin subject to local laws (although this would be subject to any other provisions in the treaty to prevent such taxation).

In addition to providing the above benefits, the issue of cross border tax avoidance clearly remains at the forefront of the minds of tax authorities around the globe. The provisions of the new treaty are in some parts eligible for use only provided that certain 'anti-treaty shopping' measures have been met.

This treaty is the second Japanese treaty to contain comprehensive limitation of benefit clauses (the first being the Japan-US treaty). Limitation of benefit clauses seek to prevent individuals or businesses 'treaty shopping' by creating conduit entities that do not generally serve any economic purpose other than to take advantage of double tax treaties (often with a view to benefiting from low rates of withholding tax).

However, the limitation of benefit provisions are restricted to a limited number of articles meaning that some of the benefits of the new treaty can be claimed without regard to these anti-avoidance provision. In general the limitation of benefit provisions are more narrow and arguably more taxpayer friendly than those contained in the Japan-US treaty.

In relation to interest, dividends and royalties (articles 10, 11 and 12), the benefits of the treaty can not be claimed in some instances if those items of income are paid to an entity that effectively has a 'back-to-back' arrangement with a third party. The conditions under which the benefits would not be available is that firstly the third party would not be able to secure the benefits of the treaty, of terms more favourable if the income was received directly by the third party and the second is that the third party is resident in neither Japan nor the UK.

In addition, there are also 'main purpose' tests introduced into a Japanese treaty for the first time. Essentially the main purpose tests provide that if one of the main purposes of the creation or assignment of the income producing asset was to take advantage of the treaty no relief will be available under each article.



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We would suggest that the new treaty makes it desirable to review holding structures in both the UK and Japan. Specifically, where necessary the new treaty withholding rates may need to be applied and exemption applied for from paying agents in either country where appropriate.

The new treaty may also impact on businesses and individuals who choose to take withholding tax as a deduction rather than a credit. In such circumstances the economic benefits of taking the withholding as a deduction rather than a credit will need to be revised (although it is usually only preferable to take tax as a deduction where there is a loss in the period).

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