

Client Alert

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Japan, Netherlands Reach Agreement on New Income Tax Treaty

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On December 18, 2009, Japan's Ministry of Finance ("MOF") announced that the governments of Japan and the Netherlands had reached agreement in principle on the terms of a renegotiated income tax treaty between the two countries. The announcement culminated a long negotiation process which began more than five years ago in June 2004.

The new treaty is of great importance in view of the substantial volume of inward and outward investment to and from Japan channeled via Dutch companies. Accordingly, the new income tax treaty between two countries may significantly affect the existing and future investments by multinational companies.

This alert highlights the key features of the renegotiated treaty as announced by the MOF.

1. Reduced Withholding Tax Rates for Dividends, Interest And Royalties

Consistent with Japan's current treaty negotiating stance with developed countries, the renegotiated treaty substantially reduces withholding rates on cross-border payments.

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	Dividends		Interest	Royalties
	Parent-Subsidiary (Ownership %)	Other		
Existing treaty	5% (25%)	15%	10%	10%
New treaty	Exempt (50%) 5% (10%)	10%	Exempt (Financial Institutions) 10% (other)	Exempt

NB: Interest and royalties paid by a Dutch resident are exempt from Dutch withholding tax under the Dutch domestic tax law.

The new exemption for parent/subsidiary dividends will benefit Japanese companies. Under Japan's recently adopted "participation exemption", 95% of dividends received from foreign subsidiaries are exempt from Japanese tax. Under this system, the 5% dividend withholding tax imposed by the Netherlands on outbound dividends has been a significant income tax cost for Japanese multinationals with Dutch holding companies since the withholding tax has been non-creditable. The exemption of dividends paid by Dutch subsidiaries from Dutch withholding tax can be expected to make the Netherlands a yet more attractive location for holding companies for Japanese multinationals.

2. Tokumei Kumiai (TK) Distributions

The new treaty will specifically address TK distributions (i.e., distributions from Japanese silent partnerships) and permit Japan to tax outbound TK distributions, consistent with terms of all tax treaties recently negotiated by Japan.

Foreign multinationals have frequently structured investments into Japan via TK structures with a Dutch silent partner because, under the prior treaty, which did not permit Japan to tax "other income" (including TK distributions) of a Dutch resident, TK distributions could be made free of Japan corporate tax and withholding tax. Accordingly, entry into force of the new treaty could substantially reduce the attractiveness of Dutch TK structures for inbound investments.

3. Limitation of Benefits Article

It was announced that the new treaty will contain a so-called limitation of benefits article, and it is expected that, consistent with Japan's treaty negotiating stance, this will be similar to those appearing in the Japan-US, Japan-UK, Japan-Australia and other recently negotiated income tax treaties. Very generally, these limitation of benefits provisions resemble similar provisions in US tax treaties, from which the concept was borrowed by Japan.

4. Items Not Yet Announced

The MOF's press release on the new treaty did not cover following items that will be of concern for multinationals and may be covered in the new treaty:

- (1) Tax treatment of capital gain derived by a Dutch resident from the disposition of shares in a Japanese company is not covered in the announcement.

The existing treaty exempts capital gains of a Dutch corporate owner of Japanese shares from Japanese tax, though such gains are taxable under Japanese domestic law (subject to minimum ownership thresholds). No clear pattern has been followed by Japan in negotiating recent treaties, with some permitting, and other not permitting, Japan to tax the non-resident on dispositions of Japanese shares, so there is a chance that the tax exempt treatment under the current treaty may change, thereby affecting foreign investors who own shares in Japanese companies.

- (2) The MOJ announcement also does not state what, if any, provision will be made in the Elimination of Double Taxation article regarding the minimum ownership ratio required for eligibility for Japan's participation exemption for dividends from a Dutch company.

Under Japan's Corporate Tax Law ("CTL"), a Japanese shareholder must own 25% of a foreign company in order to qualify for the "participation exemption" but CTL Article 23-3 specifically provides that a different minimum ownership ratio specified in a tax treaty will override the 25% minimum ownership requirement, so there is scope for the new Netherlands treaty to expand the availability of the participation exemption for dividends from Dutch subsidiaries of Japanese companies.

5. Effective Date

The new treaty will require signature by both governments and will be subject to ratification before it enters into force so the actual effective date is not yet known.

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