

Client Alert

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In This Issue:

Proposed Legislation on
Withholding Tax on Repo Margins

The Japanese Government Proposes Withholding Tax Reform for Repo Margins

On January 23, 2009, the Japanese government submitted proposed tax legislation to the Diet that would expand the application of withholding tax to repo margins with effect from April 1, 2009, together with a package of numerous proposed reforms. This Client Alert focuses on the proposal to expand withholding tax on repo margins. For other reform proposals, please refer to our separate Client Alert dated December 15, 2008.

Background – Successful Litigation Against Imposition of Withholding Tax on Repo Margins

Baker & McKenzie Tokyo recently represented a financial institution (“Taxpayer”) in tax litigation involving withholding tax on repo transactions in which the Taxpayer was the seller/repurchaser, i.e., “borrower.” The National Tax Agency (the “NTA”) made a reassessment against the Taxpayer, asserting that the Taxpayer failed to withhold on the repo margins it had paid to its repo counterparties. Baker & McKenzie Tokyo was successful in obtaining court decisions in favor of the Taxpayer at both the district and the appellate levels, whereby the courts held that repo margins are not to be construed as “interest” for withholding tax purposes. The Supreme Court rejected an appeal made by the NTA and the appellate court decision became final.

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“Interest” for Japanese Withholding Tax Purposes

Under current domestic tax law, interest paid to non-residents is subject to 20% withholding tax at source.¹ “Interest” is simply defined as “interest with respect to loans made to a person operating a business within Japan.”² One of the main issues raised in the above litigation was whether repo margins, or the difference between the initial sales price and the subsequent repurchase price, fall within the definition of “interest” for withholding tax purposes. The Diet, while the above litigation was in progress, approved a government

¹ A reduced tax rate may apply by way of applicable tax treaties.

² Income Tax Law, Art. 161(6).

proposal to add a new provision (Article 42-2) to the Special Taxation Measures Law (“STML”). The new provision is, in effect, a safe harbor rule sheltering certain qualified repo margins from withholding tax, based on the understanding that, as a threshold issue, repo margins are “interest” for withholding tax purposes.

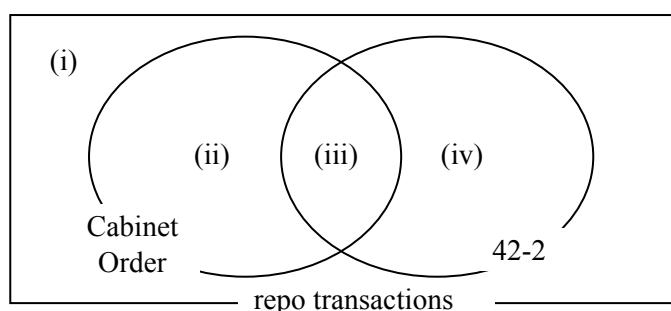
Holdings by the Courts

The courts, however, have since found that the meanings of the terms “interest” and “loans” used in the definition should be construed in accordance with the meanings of those terms as they apply in the civil law context. This stems from the fact that these terms were originally adopted from the civil law, and there is no reason to deviate in the tax context from the meanings that were initially assigned under the civil law. The courts therefore held that repo margins are not “interest” for withholding tax purposes since repo transactions are a combination of a sale and a subsequent buyback, rather than a secured loan in the civil law sense, effectively rejecting the position taken by the government in Article 42-2 of the STML and rendering that provision invalid.

The Proposal – Reaction by the Government

In response to the court decisions, the government advanced the current proposed legislation that would amend the definition of “interest” for withholding tax purposes to explicitly include certain repo margins specified by Cabinet Order. Although the Cabinet Order will only be issued after the proposed legislation successfully passes the Diet, we speculate that the Cabinet Order will most likely cover the safe harbor rule in Article 42-2 of the STML in order to “reactivate” the same. To what extent the Cabinet Order will cover transactions beyond the scope of Article 42-2 is not known, but it is expected that the Cabinet Order will identify transactions outside the scope of Article 42-2 in which repo margins will be subject to withholding tax.

The likely effect of the Cabinet Order can be displayed as follows.



- (i) No withholding tax (not covered by Article 161)
- (ii) Subject to withholding tax (covered by Article 161 by virtue of the upcoming Cabinet Order)
- (iii) No withholding tax (covered by Article 161 under the upcoming Cabinet Order but within the safe harbor withholding exemption of Article 42-2)
- (iv) No withholding tax (not covered by Article 161 because outside scope of Cabinet Order even though covered by Article 42-2)

Currently there is no Cabinet Order in effect, and therefore (ii) and (iii) do not exist.

Effect of the Proposal

As explained above, under current tax law as interpreted by the Japanese courts in the litigation discussed above, any repo margin is, in theory, free from withholding tax as long as the underlying repo transaction is a combination of a sale and a subsequent repurchase rather than a loan in the civil law context, effectively setting aside Article 42-2 of the STML. Thus, currently taxpayers do not need to rely on Article 42-2 to obtain exemption from withholding tax on any repo transaction. Although the Cabinet Order has not been issued yet, we expect that it will make it necessary for taxpayers to follow Article 42-2 requirements in order to obtain a withholding tax exemption as long as the repo transaction is a type covered by 42-2.

The Principle of “Tax Follows Civil Law Characterization” Reaffirmed

The above court decisions may be understood as part of a series of reaffirmations of the basic principle that the tax treatment of transactions must be based on the same characterization as that which applies for underlying transactional law purposes. Unlike some jurisdictions such as the US where many terms are given a tax-specific meaning, Japanese tax law frequently uses concepts and terms adopted from other fields of law, and therefore relies heavily on “adopted concepts,” especially from civil law. This principle has been strongly supported by the vast majority of court precedents, as well as tax scholars and attorney practitioners (but not necessarily by the tax authorities or non-attorney tax advisors). In some cases, however, the authorities appear to be attempting to deviate from this principle, typically using what they call a “substance over form” approach.

We trust, nonetheless, that the “tax follows civil law” transaction characterization principle will continue to be supported by the courts and the legal community for the sake of foreseeability and clarity, which are perhaps the most essential components of modern constitutions and tax law. We also believe that this case highlights the importance of an integrated and thorough analysis of the underlying laws (private laws) when structuring transactions.