Japan's Tax Treaties

Present Situation & Significance

By Satoshi WATANABE

Progressing Globalization & International Taxation

PROGRESSING globalization, though being worn-out words, has grown more significant for business operations of companies. Globalization of business operations means that companies are taxed in multiple countries. Even in one country, tax problems are cumbersome enough for any company. When any company is taxed in multiple countries, tax problems are far more complicated.

As far as international economic relations are focused on trade in goods, international taxation problems are not so serious. The matter of tariffs is a problem with international trade in goods. But there is an international consensus that tariffs, which are special taxes imposed on goods subject to cross-border trade, should basically be reduced and eventually eliminated. Existing tariffs represent an international trade problem rather than an international taxation problem.

When Japanese companies found subsidiaries in foreign countries or set up overseas joint ventures with foreign partners, however, they face complicated international corporate taxation problems. In countries where Japanese firms have founded subsidiaries or joint ventures, they have to pay corporate and other taxes. If they repatriate profits earned in these host countries, they face relevant taxation in their home country. Furthermore, foreign host countries may often withhold tax on profits upon such repatriation. If there is no coordination made between the home and host country governments, international double taxation may emerge. Tax treaties play a key role in solving the problem of double taxation.

Japanese companies have expanded into many foreign countries. Some companies have larger production operations overseas than in Japan. Some earn more overseas than they do in Japan. In the meantime, a growing number of foreign companies have expanded into Japan. Such international investment exchanges are indispensable for Japan's economic growth. In this respect, international taxation problems should be prevented from impeding companies' international operations. If international business operations allow companies to evade tax, national tax authorities must seek to avoid tax evasion. Tax treaties are thus required to avoid both double taxation and tax evasion.

Objectives of Tax Treaties

Tax treaties function as a basis to coordinate national taxation rights to prevent such problems as international double taxation from impeding international business operations and secure cooperation between national tax authorities in fighting international tax evasion. Even without tax treaties, any country may avoid international double taxation to some extent by developing relevant domestic tax measures such as a foreign tax credit. But coordination under domestic tax law alone may often be insufficient. In some countries, domestic coordination mechanisms may be inconsistent with those of other countries. Any bilateral tax treaty can encourage the two relevant countries to positively take advantage of taxation rights coordination for expanding investment exchanges.

Any bilateral tax treaty that Japan concludes is officially titled the "Convention between the Government of Japan and the Government of (a foreign country) for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income." As indicated by the official title, any bilateral tax treaty is primarily aimed at avoiding double taxation and preventing tax evasion. In recent years, however, the promotion of investment exchanges has been identified as an even more important objective of such a treaty. In fact, a Japanese policy planner in a speech in 2007 said, "We have given priority to the promotion of investment exchanges (as the objective of tax treaties) over the recent years." The promotion of investment exchanges has been occasionally viewed as a greater objective of

Table Overview of tax treaties

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Coordination regarding double taxation
– Bilateral coordination of national taxation rights
– How to eliminate existing double taxation

Response to tax avoidance
– Exchanges of information & consultations between tax authorities
– Measures to prevent the treaty from being abused

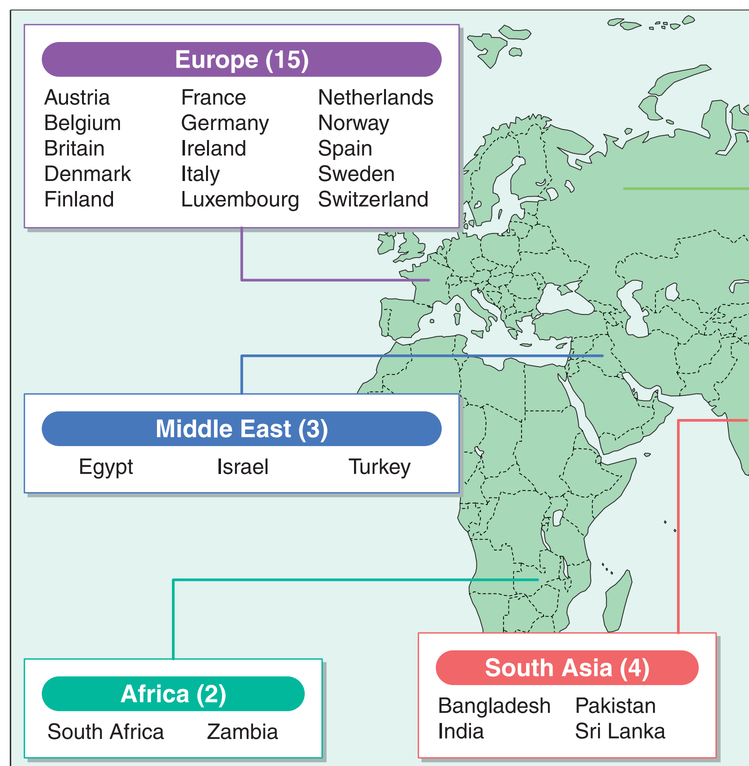
Promotion of investment exchanges
– Reduction of tax burden on investment income in investment-destination countries
– Nondiscriminatory provisions

Criteria for selection of negotiation partners

1. Depth of bilateral economic exchanges
2. Investment income tax rates in countries where Japanese firms operate
3. Balance between competitive conditions for Japanese and other firms in foreign countries
4. Presence or absence of matters to be solved under existing tax treaties

Source : *Ministry of Finance*

Chart



Source : *Ministry of Finance*

tax treaties than the avoidance of double taxation and the prevention of tax evasion regarded as traditional objectives because interdependence between national economies has become decisively important in line with globalization of business operations *(Table)*.

Effects of Tax Treaties

What are tax treaties' advantages for business operations? Basically, tax treaties often make taxation more favorable for companies. More precisely, there is a principle that no tax treaty should work to the disadvantage of taxpayers.

But tax treaties may not necessarily work to lower tax contributions. If domestic law exists to appropriately avoid double taxation in the absence of a tax treaty, any tax treaty could fail to further lower tax burdens. (In some cases, tax payment deadlines may change to the advantage of taxpayers under a tax treaty even if total contributions remain unchanged.) But coordination through domestic law may not be necessarily sufficient. A country's tax system may not necessarily be consistent with those in other countries. Then, double taxation may not be eliminated appropriately without a tax treaty. Through a bilateral tax treaty, the two relevant countries make mutual concessions regarding taxation rights to secure the elimination of double taxation.

Tax treaties may also allow taxpayers to file complaints against tax measures running counter to such treaties and prompt tax authorities to hold consultations. Such a consultation system may work to reduce taxation risks for taxpayers.

Tax treaty provisions for exchanging information and avoiding abuse of such treaties may impose even greater burdens on taxpayers than in the absence of such treaties. When any tax treaty works to the disadvantage of some taxpayers, however, the taxpayers rather than the treaty may be responsible for the disadvantage.

Present & Recent Trends of Japan's Tax Treaties

As indicated by *Chart,* Japan has so far concluded 45 tax treaties covering 56 foreign countries. The tax treaty network covers most foreign countries with which Japan has major economic relations. But it is not comprehensive. Over the past years, Japan has attempted to expand the network further. For example, Japan has conducted tax treaty negotiations with Kuwait and the United Arab Emirates among Middle East countries that have no such treaties with Japan. It has also launched talks with Kazakhstan. In the future, Japan will have to conclude tax treaties with Latin American and African countries. In Asia, Japan has yet to have treaties with Hong Kong and Taiwan.

Japan has also revised some existing tax treaties quickly over the past years. In only two yeas after a Japan-U.S. tax treaty was revised substantially in 2004, Japan concluded revised treaties with Britain, India, France, Australia, Pakistan and the Philippines.

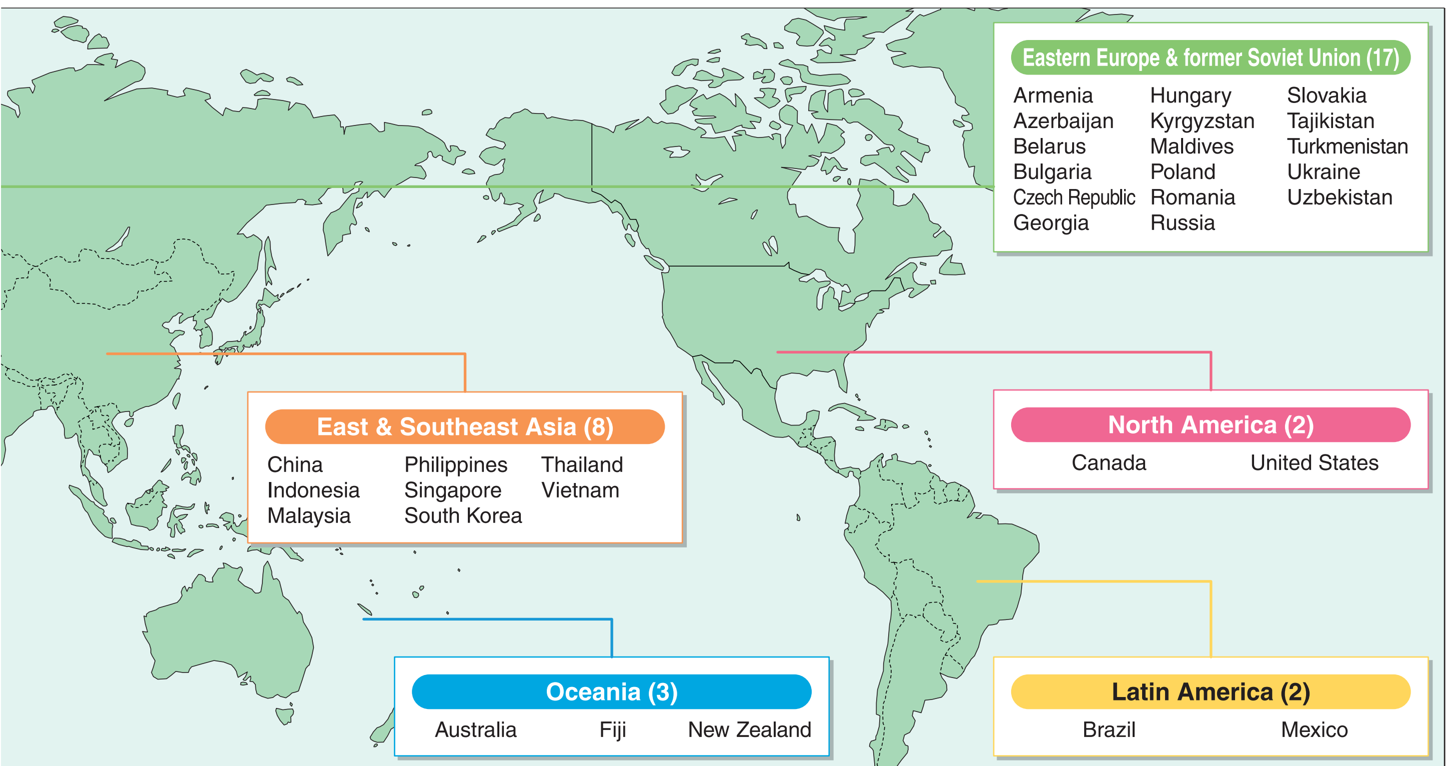
Recent tax treaty revisions feature lowered withholding tax on investment income such as interest, dividends and royalties in investment-destination countries. For example, tax treaties with industrial countries exempt tax on royalties in principle. Withholding tax rates have generally been lowered on interest and dividend income. Financial institutions' interest and dividend payments from subsidiaries to their parents are exempted from taxation in many cases.

Tax treaties with industrial nations also feature provisions to prevent taxpayers from abusing benefits under such treaties. Those with developing countries have recently tended to eliminate the so-called tax-sparing credit system for deduction of foreign taxes deemed paid. Under the system, Japanese firms' overseas subsidiaries are regarded as having paid full corporate tax in foreign countries where they operate and deduct the deemed overseas tax payments from their Japanese tax liability, regardless of any tax benefits they may have received under tax incentives introduced by these countries to attract investment.

OECD Model Treaty

Tax treaties are concluded on a bilateral basis. Therefore, their contents can vary depending on bilateral agreements between specific countries. Nevertheless, real tax treaties are similar. This is because international organizations have created and developed model tax treaties over a long term. Particularly important

Japan's tax treaty network (Applied to 56 countries as of November 2007)



is an OECD model treaty, the Model Double Taxation Convention on Income and Capital, developed by the Organization for Economic Cooperation and Development.

The OECD itself has no power to order any country to take any specific policy. A tax treaty has a fundamental element of confrontation between partner countries in terms of securing national taxation rights. In reality, however, it is very difficult for any country to deviate from a well-developed model treaty. Tax treaty negotiations usually include coordination of disputes over taxation rights. If there is a well-developed model treaty, therefore, any deviation from the model may work to the disadvantage of either country. Unless one party can fully persuade the other to deviate from the model, it may be difficult for them to reach an agreement deviating far from the model. As a result, the OECD model treaty has become an effective global standard for tax treaties. Bilateral tax treaties, including those of Japan, have grown more susceptible to the influence of the OECD model over the recent years. The OECD has played a key role in developing international taxation rules in addition to the model treaty. Its role in this area is expected to grow even more significant.

Future Role of Tax Treaties

Globalization of economic activities has reduced the economic significance of national borders. Economic operations now depend on free cross-border flows of humans, goods, money and information. But countries may never disappear. Therefore, borders may remain. As far as countries exist, taxation will remain. Although national tax systems have grown more susceptible to the impact of globalization of economic activities, national taxes may never disappear.

Therefore, international taxation problems involving national taxes on international economic operations may never disappear in the immediate future. Under such a situation, countries must harmonize their national taxation systems to prevent taxes from impeding economic operations. In this respect, the role of tax treaties is very important. For the immediate future, Japan must expand its tax treaty network and promote revisions of existing treaties. In the future, Japan may have to consider multilateral tax treaties in addition to bilateral ones.

As the weight of global economic operations increases, tax treaty frameworks may have growing impact on domestic law. Through this process, national tax systems may be coordinated effectively. Therefore, a future tax treaty policy may have to be considered from a wide range of perspectives. JS

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