



BDO Seidman, LLP
Accountants and Consultants

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Issue:
**New U.S.-Japan
Income Tax
Treaty**

International Tax Alert

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Date\Timing:

On November 6, 2003, a new income tax treaty was signed between the U.S. and Japan. It was ratified by the U.S. Senate on March 9, 2004 and was ratified by the Japanese Diet on March 19. The exchange of Instruments of Ratification took place in Tokyo on March 30, 2004. The treaty will take effect with varying effective dates, beginning July 1, 2004. The current treaty has stood since 1971.

Affecting:

Firms with U.S.-Japan cross-border activity.

Details:

The treaty eliminates withholding taxes on arm's-length royalty income (5% remains on excessive royalty income.)

In general, the treaty imposes a 10% rate of withholding on interest. However, interest earned by certain entities may qualify for a zero rate of withholding. This may include interest earned by:

- Financial Institutions
- Pension Funds
- Government-sponsored entities
- The sale of equipment or merchandise on credit

The treaty eliminates or reduces withholding tax on certain dividends:

- Eliminates withholding on subsidiary dividends (more than 50% ownership for at least 12 months required)
- Eliminates withholding on dividends paid to pension funds
- Reduces withholding on dividends paid to 10% voting shareholders from 10% to 5%
- Reduces withholding on RIC and REIT dividends from 15% to 10% (some exceptions)
- Reduces withholding on other dividends from 15% to 10%

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Details ...(continued)

The treaty imposes branch profits tax on deemed dividends, deemed interest, and deemed royalty payments generally at 5%. It exempts branch operations of companies that are publicly traded in either country (subject to certain qualifications).

The treaty also allows that the treaty will apply to qualified members of flow-through entities, such as partnerships and limited liability companies.

The treaty provides expanded guidance on the treatment of stock option income involving a taxpayer who performed services in both the U.S. and Japan and could otherwise be subject to income tax in both countries.

Finally, the treaty specifically denies benefits to conduit arrangements and limits its benefits to those taxpayers who meet certain tests, thereby limiting abuse and treaty shopping.

A protocol to the treaty provides that transfer pricing examinations will be conducted consistent with OECD guidelines. This includes a provision that only pricing methods consistent with OECD guidelines be applied.

Recommended Action:

- Refresh existing transfer pricing studies related to US-Japanese activity in light of new provisions
- Critically review intermediate country entities otherwise used to reduce withholding
- Borrowers from US branches of Japanese financial institutions might now be able to efficiently borrow directly from parent in Japan
- Cross border investors may now wish to review prior decisions in view of more favorable taxes on dividends
- Review of any 'check-the-box' entities and structures
- Review of stock option income, especially for expatriates to or from Japan

FOR MORE INFORMATION

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