

ASG tax news

ASG Tax Corporation
Quarterly Newsletter
January 2004

Grant Thornton 



Our news letter provides information on Japanese tax and business which we believe is of interest to international companies doing business in Japan.

1. US-Japan Tax Treaty

On November 6, 2003 the governments of Japan and the United States signed a new tax treaty, the first update to the agreement since 1971. It is expected to be enacted in January 2005 after ratification by both governments. This new treaty restricts to a greater extent than the existing treaty the right of a contracting state to impose taxes on income arising in their state from many types of transactions that take place between companies and individuals doing business in both countries.

Key changes in this new tax treaty include the elimination of withholding taxes on royalties, certain inter-company dividends, and certain types of interest income. The taxation of stock option benefits has been included in the treaty to address this relatively new type of employee compensation. Also, the tax treaty now has provisions clarifying the applicability of the treaty to hybrid entities, other income, Tokumei Kumiai distributions, and limitations on eligibility to enjoy the benefits of the treaty. Summaries of these new provisions follow.

a) Royalties

Under the new treaty, royalties will be exempt from source country taxation. If a U.S. company or individual receives royalty income from a company in Japan, the royalty is currently subject to a 10% withholding tax. This withholding tax will be eliminated when the new treaty is enacted. If a royalty paid to a related party is deemed to be above the fair market value, then a 5% withholding tax will be levied on the excess amount.

Note that the treaty restricts the use of sub-licensing arrangements that are set up to reap the benefits of the tax

treaty. The beneficial owner of the property that is the subject of the royalty must be a resident of one of the contracting states in order for the treaty provision to apply. A non-U.S. or non-Japanese entity that licenses intellectual property to a U.S. or Japanese company, which then sub-licenses that intellectual property to a company in the other contracting state will not benefit from this provision.

b) Inter-company dividends

Dividends paid between parent and subsidiary companies will be exempt from source country withholding tax under the new treaty. The definition of a parent company is a company that has owned, either directly or indirectly, greater than 50% of the voting shares of the subsidiary company for the 12-months prior to the date the dividends are declared. Under the existing treaty, these dividends were subject to a 10% withholding tax. This provision only applies if the beneficial owners of the shares are residents of the contracting states. If a company is registered in the United States and controls a Japanese subsidiary, the tax treaty provision will not apply if greater than 50% of the voting shares of the U.S. company are owned by shareholders who are resident in third countries. An exception to this rule is when a recipient company is listed on a stock exchange in its home country. In such a case, tracing the residency of every shareholder throughout the year would be prohibitively expensive and so this rule would not be enforceable.

c) Interest income

As in the existing treaty, interest income is subject to a 10% withholding tax. However, the categories of interest income that are exempt from this withholding tax have

been expanded. Interest income earned by governments, central banks, institutions that are wholly-owned by government, and certain financial institutions will not be subject to withholding tax under the new treaty. Eligible financial institutions include banks, insurance companies, registered securities dealers, and other institutions with greater than 50% of liabilities as debt instruments or interest bearing deposits, and greater than 50% of assets as credit instruments. Interest arising from the sale of equipment or merchandise on credit will also be exempt from withholding taxes.

d) Taxation of stock option benefits

When an employee has been granted stock options by their employer, and is transferred overseas during the time between the grant and exercise of the options, then double-taxation may arise if both countries claim that the benefit realized upon the exercise of the stock options was actually earned while the taxpayer was resident in their country. In order to address this issue, the new tax treaty specifically states that when the countries involved are the contracting states, the employee will only be liable to pay taxes on the portion of the benefit that arose while resident in each state, and requires that the tax authorities of Japan and the U.S. negotiate and agree upon the portion that will be taxable in each country.



e) Hybrid entities

“Hybrid entities” are entities whose tax status differs by country. For example, a company may be considered a corporation under Japanese law, but may be a partnership under U.S. law. The applicability of the U.S.-Japan tax treaty for such entities will depend on the residency status of the individual members of the entity.

For example, a U.S. LLC (limited liability company) is considered to be a corporation under Japanese tax law, but may be considered a partnership under U.S. tax law. As a partnership, no tax is assessed at the LLC level. Each member’s share of the LLC’s income is taxed in his or her hands. If the U.S. LLC invests in a Japanese corporation and receives dividends, the benefits of the tax treaty will apply only to those members of the LLC who are residents of the U.S.

f) Other income and Tokumei Kumiai

The existing U.S.-Japan tax treaty does not address the treatment of income of a type other than those defined in

the treaty. The new treaty specifically states that “other income” will be taxed in the country of the recipient’s residence.

A Tokumei Kumiai (TK) is a contract between a business operator and a TK partner whereby the TK partner contributes cash or other assets to the business operator for use in a certain business, and is entitled to receive an allocation of profits and losses arising from the business. The income earned by the business operator flows through to the TK partners and is taxed in their hands. If the “other income” article is applied to TK profit allocations, income could be distributed to a foreign TK partner without being taxed in Japan. Because of loopholes in tax treaties between Japan and other countries, Tokumei Kumiai have been used for international tax avoidance transactions. Under the new tax treaty, TK’s are specifically excluded from the benefits of the “other income” article. This will enable the Japanese tax authorities to tax at source income distributed overseas by the TK.

g) Limitation on benefits

The new tax treaty now includes a provision limiting eligibility for the benefits of the treaty. This could cause entities that benefit from the provisions of the current treaty to lose those benefits when the new treaty is enacted. As such, it is vital that affected entities examine the new treaty and make any necessary rearrangements to their structures before the new treaty comes into effect.

2. Taxation of Stock Option Benefits

The taxation of stock option benefits has attracted much attention of late, as recent Japanese court rulings on this issue have challenged the National Tax Agency’s (NTA) treatment of such income. Stock options have not generally been used by Japanese companies as a form of employee compensation, so the recent court cases all involved Japanese taxpayers who had received stock option benefits from foreign companies in their capacity as employees of a Japanese subsidiary.

The Rulings

The recent court rulings have been in favour of the taxpayers. Under Japanese Income Tax Law, the benefit realized upon exercise of a stock option is taxed when exercised for the difference between the fair market value of the stock and the exercise price, unless the stock option is a “qualified” plan. Qualified plans, as defined in the



Tax Law, may only be set up by Japanese joint stock companies (kabushiki kaisha). Although there is no specific rule in the Japanese law code regarding the character of stock option benefits, the NTA has treated the benefit received as

employment income, because the taxpayers received the stock options and thus the exercise benefits in their capacity as employees. However, the Tokyo District Court (TDC) decided, in rulings in November, 2002, August, 2003 and September 2003, that the benefits resulted from the market conditions and the choices made by taxpayers as to when to exercise the options. The amount of the benefit would change depending on the decisions the taxpayers made, and therefore could not be said to result from services rendered as an employee. The fact that the stock options were received not from the taxpayers' direct employers but from the employers' parent companies also added to the argument that the benefits received as a result of exercising the stock options were not employment income.

The TDC ruled that this exercise benefit should be classified as "occasional income". The amount of tax assessed on occasional income is less than that assessed on employment income because only 50% of occasional income is taxable. Additionally, there is a JPY 500,000 annual statutory exemption on occasional income. The following example is for a situation where a taxpayer, who is a permanent resident of Japan, receives a JPY 1,000,000 benefit from the exercise of stock options during the year and faces a 40% marginal tax rate. The stock option exercise benefit is the only occasional income received by the taxpayer during the year.

Income Tax Payable on JPY 1,000,000 stock option benefit:

Employment income treatment – JPY1,000,000 * 40% = JPY 400,000

Occasional income treatment – (JPY 1,000,000 – JPY 500,000 statutory exemption) * 50% * 40% = JPY 100,000

Tax savings due to treatment as occasional income = JPY 300,000

As the example illustrates, the recent tax rulings confer a considerable benefit on the taxpayer. However, these TDC rulings have been appealed by the NTA to a higher court so until new legislation is introduced codifying the tax treatment of stock option benefits, or until the NTA loses on appeal to the higher court or drops its appeals, the tax treatment of stock option benefits will remain uncertain.

Note that all the precedent court decisions on stock option benefits up to now have dealt with taxpayers who received stock option benefits from a foreign company that was not their direct employer. Therefore, these rulings may not apply to situations where the stock option benefits are received from immediate employers.

If a taxpayer has already paid tax on stock option benefits treated as employment income, then s/he may consider applying for a refund of the difference between the taxable amount when assessed as employment income and the taxable amount when assessed as occasional income. The deadline for applying for a refund is one-year after the filing deadline of the applicable tax year. Therefore, for the 2002 tax year, whose filing deadline was March 15, 2003, the refund application deadline will be March 15, 2004. For the 2003 taxation year, taxpayers may choose to treat stock option benefits as occasional income and pay the lower amount of tax. However, this method does risk the NTA reassessing the taxable amount and charging interest and penalties. The recent court rulings do not place an obligation on the NTA to stop its practice of treating stock option benefits as employment income.

3. Intra-Group Services – New Transfer Pricing Article

Japanese transfer pricing guidelines have received further clarification with the release on June 20, 2002, of a new article of the Commissioner's Directive on the Operation of Transfer Pricing (June 1, 2001), which is the internal guidance of the NTA to its auditors involved in transfer pricing audits. This new article deals specifically with the treatment of intra-group services, such as accounting assistance, planning and coordination assistance, design and marketing support, and employee recruitment and training services. Such intra-group services are not as visible as intra-group transactions that involve tangible items, such as inventory, and are therefore more difficult to identify and assess.

Before the introduction of this new article, the NTA had not scrutinized intra-group services during their examinations of transfer pricing, as there were no explicit guidelines in Japan for the treatment of such transactions. However, as Japan has relatively high corporate tax rates, the NTA felt the need to extend their enforcement of the transfer pricing rules to the area of intra-group services. The alternative would be to see a drain in tax revenues as multinational companies reduce their overall tax burdens by transferring income to regions with lower tax rates by way of excessively high charges for intra-group services provided by foreign related parties.

According to the published guidelines, when assessing intra-group services for transfer pricing compliance the two key questions to ask are:

1. Does the service provided have a commercial value?
2. If commercial value is present, what is the appropriate arms-length price for the service?

Commercial Value

“Commercial value” is defined as being present if the services would be purchased from a third-party or done in-house if not performed by the foreign related party. This definition means that we must look not at the incremental cost incurred by the provider of the service, but at the benefit realized by the recipient of the service when considering commercial value. A company which had previously given little thought to the benefits it receives from intra-group services should take an inventory of the various services it receives from foreign related parties and consider what it would do if suddenly these services were no longer provided. If the conclusion is that it would expend economic resources to obtain these services from a third-party, or hire additional staff or pay more to existing staff to perform the service in-house, then the existence of “commercial value” will be apparent.



Standby Charges

When considering which services have commercial value, the analysis must extend to services that are not regularly used but are available to be used at any time if the situation warranted. For example, a parent company may maintain a disaster recovery site, which could be used by a subsidiary in the event of an information systems failure. If the parent company did not have such a facility available, the subsidiary would have to contract with a third-party service provider or develop resources in-house to prepare for an information systems failure. Regardless of whether the facility is actually utilized by the subsidiary or not, the fact that the facility is available for its use at all times indicates that commercial value is present. Such “stand-by charges” are to be included in the transfer pricing analysis and cannot be overlooked.

Duplicate Services

The guidelines specifically exclude “duplicate services” from services with commercial value. For example, a subsidiary may have an internal audit department, but also

receive visits from the internal auditors of the parent company. If the parent company auditors stopped visiting the subsidiary, and in response to this the subsidiary would *not* feel the need to increase the work performed by its own internal audit department, then the parent company internal audit work is a duplication of the subsidiary’s existing internal audit function and so does not constitute a service with commercial value. However, the guidelines provide for two exceptions to this rule.

If the service duplicates an existing service, but this duplication is temporary, then the service may have commercial value regardless of this duplication. In a situation where the company is changing its disaster recovery systems, there may be a brief period when the same service is being provided by two sources. In this situation, both services would be considered to have commercial value.

If the reason for the duplication is to reduce the risk of a poor business decision being made, then the duplicate service is considered to have commercial value. In the case of the internal audit example above, if the additional oversight of the parent company’s internal audit department was considered necessary to reduce the risk of a wrong business decision being made, then the duplicated service is considered to have commercial value.

Shareholder Activities

Activities performed by the parent company in its capacity as a shareholder of a subsidiary should not be confused with services that have commercial value. For example, the parent company may expend resources preparing consolidated financial statements for the corporate group, but if the subsidiary was an independent company, it would not pay to have consolidated statements prepared. The consolidated statements are required by the parent company as a part of its own reporting requirements and cannot be said to be a service with commercial value from the perspective of the subsidiary.

Valuation of services

Once the existence of commercial value has been established, the next step is to determine an appropriate arms-length price for the service. The new article does not provide guidance on how such a price should be determined. Therefore, the valuation methods used for intra-group transactions involving tangible items should be used to determine a reasonable arms-length price. Unlike valuations for transactions involving tangible assets, the NTA does not require a mark-up on cost for intra-company service transactions when the comparable uncontrolled price method or cost-plus method are not

applicable. The reason for this is the difficulty in determining an appropriate markup rate. It is important to remember that consideration must be given to both the direct and indirect costs incurred to provide the service. No matter what method is used to determine an appropriate transfer price, documentation must be prepared and retained to show investigators how the transfer price was arrived at.

Other considerations

Although more and more countries are working to harmonize their tax treatment of intra-company international transactions, differences still exist which could lead to double-taxation. This occurs when one country requires inclusion in income of consideration for intra-company services provided, while the authorities of the country where the receiving company resides may deny the existence of a commercial value to the service provided and so deny the deduction of the corresponding expense. Countries also may have different regulations regarding the obligation to withhold taxes on amounts paid with respect to intra-company services. Because of such regulatory differences, it may be beneficial for multinational companies to develop strategies to help them minimize their international tax burden and to avoid any unexpected double-taxation situations.

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