



KPMG Japan Tax Newsletter

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NEW TAX TREATY WITH RUSSIA

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On 7 September 2017, the government of Japan and the government of the Russian Federation signed the 'Convention between the Government of Japan and the Government of the Russian Federation for the Elimination of Double Taxation with respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance' (New Tax Treaty).

The New Tax Treaty will supersede the 'Convention between the Government of Japan and the Government of the Union of Soviet Socialist Republics for the Avoidance of Double Taxation with respect to Taxes on Income' (Current Tax Treaty) that entered into force in 1986. The New Tax Treaty is broadly in line with the OECD Model Tax Convention^(*) and the Multilateral Instrument (MLI)^(**).

(*) The draft of the 2017 update for the OECD Model Tax Convention that reflects recommendations presented in the final reports of the Base Erosion and Profit Shifting (BEPS) project was released on 11 July 2017 for public comments.

(**) The MLI (the formal title: 'Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting') was prepared based on the recommendation of Action 15 of the BEPS project and was signed by 67 signatories on 7 June 2017. The MLI is a mechanism to reflect recommendations under the BEPS project in existing tax treaties in an efficient manner. Although Japan and Russia signed the MLI, as both countries did not choose the Current Tax Treaty as a Covered Tax Agreement of the MLI, the MLI will not apply to either the Current Tax Treaty or the New Tax Treaty.

Note that the Current Tax Treaty is applicable not only to Russia but also to 10 jurisdictions that constituted the ex-USSR (Republic of Armenia, Republic of Azerbaijan, Republic of Belarus, Georgia, Kyrgyz Republic, Republic of Moldova, Republic of Tajikistan, Turkmenistan, Ukraine and Republic of Uzbekistan). The Current Tax Treaty will not be amended in terms of the application with such jurisdictions.

We have set out in this newsletter an outline of the features of the New Tax Treaty.

1. Dividends (Article 10)

The reduced tax rates on dividends will be amended as follows:

Current Tax Treaty	New Tax Treaty	
	Beneficial owners	Reduced tax rates
15%	Pension fund	0%
	A company which has owned directly at least 15% of the voting power of the dividend paying company for the period of 365 days ending on the date on which entitlement to the dividends is determined	5%
	Other than the above	10%

《Notes for the New Tax Treaty》

- A reduced tax rate of 15 percent will be applied to dividends derived by a resident of a Contracting State from shares of a company or comparable interests if, at any time during the 365 days preceding the payment of the dividends, these shares or comparable interests derived at least 50 percent of their value directly or indirectly from immovable property situated in the other Contracting State.
- The reduced tax rate of 5 percent will not apply in the case of dividends which are deductible in computing the taxable income of the company paying the dividends in the Contracting State of which that company is a resident.

2. Interest (Article 11)

The reduced tax rates on interest will be amended as follows:

Current Tax Treaty		New Tax Treaty
Interest derived by governments or central banks, etc.	0%	0%
Other than the above	10%	

《Notes for the New Tax Treaty》

A reduced tax rate of 10 percent will be applied to contingent interest payments (payments of interest determined by reference to receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor or a related person, or any other interest similar to such interest).

3. Royalties (Article 12)

Royalties will be tax exempt in the source country under the New Tax Treaty.

Current Tax Treaty		New Tax Treaty
Royalties on copyrights	0%	0%
Royalties on patents and equipment, etc.	10%	

《Notes for the New Tax Treaty》

Under the New Tax Treaty, consideration for the use of equipment will not be covered under this article. It is generally understood that the business profits provision is applicable to consideration for the use of equipment unless the other provisions such as the royalties provision specifically cover such consideration.

4. Capital Gains (Article 13)

The provision for capital gains will be amended as follows:

Capital gains derived by a resident of a Contracting State from the alienation of:	Taxing rights by the other Contracting State	
	Current Tax Treaty	New Tax Treaty
Immovable property situated in the other Contracting State	Yes	Yes
Property forming part of the business property of a permanent establishment in the other Contracting State	Yes	Yes
Shares of a legal person being a resident of the other Contracting State	Yes	
Shares in a company or comparable interests, where at any time during the 365 days preceding the alienation, these shares or comparable interests derived at least 50% of their value directly or indirectly from immovable property situated in the other Contracting State ^(*)		Yes
Ships or aircraft operated in international traffic	No	No
Any property other than the above	No	No

^(*) Where such shares or comparable interests are traded on a recognized stock exchange and the resident and persons related to that resident own in the aggregate 5 percent or less of the class of such shares or comparable interests, the taxing right on the capital gains will not be granted to the other Contracting State.

5. Other Income (Article 20)

Under the Current Tax Treaty, other income (income not dealt with in individual provisions) derived by a resident of a Contracting State is generally taxed only by that Contracting State. However, under the New Tax Treaty, if there is such other income arising in the other Contracting State, the taxing right on such income will be granted to that other Contracting State as well.

Therefore, for example, distributions of income arising in Japan in respect of a silent partnership to a partner being a resident of Russia will be subject to Japanese withholding tax at 20.42 percent including special reconstruction income tax under the New Tax Treaty.

6. Entitlement to Benefits (Article 21)

Article 21 (Entitlement to Benefits) will be added in the New Tax Treaty in line with Article 29 (Entitlement to Benefits) of the OECD Model Tax Convention, which is proposed to be introduced under the draft of the 2017 update for the OECD Model Tax Convention.

(1) Limitation on Benefits/LOB

The commentary to Article 29 of the draft of the 2017 update for the OECD Model Tax Convention includes proposed texts for the LOB clauses (both detailed version and simplified version). Paragraphs (1) to (6) of Article 21 of the New Tax Treaty provide for the LOB clauses, which is in line with the simplified version of the OECD LOB clauses. Note that although the OECD LOB clauses are applied to all treaty benefits in principle, the LOB clauses of the New Tax Treaty will be applied only to specified treaty benefits (tax exemption for dividends, interest and royalties).

Therefore, where a resident of a Contracting State wishes to claim tax exemption for dividends, interest or royalties in the other Contracting State, the resident must satisfy one of the following tests from A to D to obtain such treaty benefits:

A. Qualified person test

A resident of a Contracting State falls under one of the following (qualified person):

- (a) an individual
- (b) a Contracting State and local authority, etc.
- (c) a listed company meeting certain conditions
- (d) a pension fund meeting certain conditions
- (e) a person other than an individual, if, on at least half of the days of any 12 month period that includes the time when the benefit would otherwise be accorded, persons that are residents of that Contracting State and that are entitled to tax exemption for dividends, interest or royalties under (a), (b), (c) or (d) above own, directly or indirectly, at least 50 percent of the shares of the person

B. Derivative benefits test

A resident of a Contracting State meets one of the following conditions:

- (a) In the case of a pension fund — at the beginning of the taxable year for which the claim to the benefit is made, at least 75 percent of its beneficiaries, members or participants are individuals who are equivalent beneficiaries.
- (b) In all other cases — on at least half of the days of any 12 month period that includes the time when the benefit would otherwise be accorded, persons that are equivalent beneficiaries own, directly or indirectly, at least 75 percent of the shares of the resident.

‘Equivalent beneficiary’ means any person who would be entitled to benefits with respect to an item of income accorded by a Contracting State under the

domestic law of that Contracting State, the New Tax Treaty or any other international instrument which are equivalent to tax exemption for dividends, interest or royalties under the New Tax Treaty.

C. Business activity test

A resident of a Contracting State meets the following two conditions with respect to dividends, interest or royalties derived from the other Contracting State:

- (i) The resident is engaged in a business activity in the first-mentioned Contracting State.
- (ii) The income derived from the other Contracting State emanates from, or is incidental to, that business activity.

'A business activity' does not include the following activities or any combination thereof:

- operating as a holding company;
- providing overall supervision or administration of a group companies;
- providing group financing (including cash pooling); or
- making or managing investments, unless these activities are carried on by a bank, insurance company or registered securities dealer in the ordinary course of its business as such.

D. Discretionary relief by the competent authority

Where a resident of a Contracting State that wishes to claim tax exemption for dividends, interest or royalties in the other Contracting State demonstrates to the satisfaction of the competent authority of the other Contracting State that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of such benefits, such competent authority can grant such benefits.

(3) Anti-abuse rule for permanent establishments situated in third jurisdictions

Paragraph (7) of Article 21 of the New Tax Treaty provides for an anti-abuse rule to prevent tax avoidance by using permanent establishments situated in third jurisdictions, which is almost the same as the rule provided for in paragraph (8) of Article 29 (Entitlement to Benefits) of the draft of the 2017 update for the OECD Model Tax Convention. Treaty benefits may not be granted to income attributable to permanent establishments situated in third jurisdictions under certain conditions.

(4) Principal Purpose Test/PPT

Paragraph (8) of Article 21 of the New Tax Treaty provides for the PPT, which is the same as the PPT provided for in paragraph (9) of Article 29 (Entitlement to Benefits) of the draft of the 2017 update for the OECD Model Tax Convention. A benefit under the New Tax Treaty will not be granted in respect of an item income in principle if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.

7. Other Notable Points

■ Title and Preamble

The title and preamble of the New Tax Treaty will be amended in line with the draft of the 2017 update for the OECD Model Tax Convention so that it can be clarified that the purposes of the New Tax Treaty are not only the elimination of double taxation but also the prevention of tax evasion and avoidance.

■ Persons Covered (Article 1)

Article 1 of the New Tax Treaty includes a new clause with respect to the treatment of income derived through a hybrid entity, which is similar to Article 1 of the draft of the 2017 update for the OECD Model Tax Convention.

■ Resident (Article 4)

New clauses with respect to the tie-breaker rules for determining the treaty residence of dual-resident persons will be introduced in Article 4 of the New Tax Treaty. The treaty residence of dual-resident persons other than individuals will be determined by mutual agreement of the competent authorities of the Contracting States, which is the same as the treatment under the tie-breaker rule of Article 4 of the draft of the 2017 update for the OECD Model Tax Convention.

■ Permanent Establishment (Article 5)

Article 5 of the New Tax Treaty will be in line with Article 5 of the draft of the 2017 update for the OECD Model Tax Convention.

- A clause with respect to the scope of agents to be treated as permanent establishments will be amended in order to prevent artificial avoidance of permanent establishment status through commissionaire arrangements and similar strategies.
- A clause to exclude specific activities from permanent establishment status will be replaced with a clause similar to an alternative clause proposed in the commentary to Article 5 of the draft of the 2017 update for the OECD Model Tax Convention, under which some specific activities do not create a permanent establishment regardless of whether or not they have a preparatory or auxiliary character. The anti-fragmentation rule will also be introduced.

■ Associated Enterprises (Article 9)

A new provision, Article 9 (Associate Enterprise), will be introduced in the New Tax Treaty, including a clause providing for corresponding adjustments.

■ Mutual Agreement Procedure/MAP (Article 24)

Although a taxpayer is allowed to raise a MAP request only to the competent authority of a Contracting State of which they are residents (nationals for certain cases) under the Current Tax Treaty, a taxpayer will be able to raise a MAP request to the competent authority of either Contracting State.

■ Exchange of Information (Article 25)

Article 25 of the New Tax Treaty will be almost the same as Article 26 (Exchange of Information) of the OECD Model Tax Convention.

■ Assistance in the Collection of Taxes (Article 26)

A new provision of Article 26 will be introduced to the New Tax Treaty in order to provide for rules with respect of procedures to lend assistance to each other in the collection of revenue claims, which is in line with Article 27 (Assistance in the Collection of Taxes) of the OECD Model Tax Convention.

8. Entry into Force (Article 29)

After the approval in accordance with the domestic procedures of the two countries (approval by the national Diet for Japan), the New Tax Treaty will enter into force on the 30th day after the date of exchange of diplomatic notes indicating such approval.

The New Tax Treaty will have effect as follows:

Taxes levied on the basis of a taxable year	Taxes for any taxable years beginning on or after 1 January in the calendar year next following that in which the New Tax Treaty enters into force
Taxes levied not on the basis of a taxable year	Taxes levied on or after 1 January in the calendar year next following that in which the New Tax Treaty enters into force

Notwithstanding the above, Article 25 (Exchange of Information) and Article 26 (Assistance in the Collection of Taxes) will have effect from the date of entry into force of the New Tax Treaty without regard to the date on which the taxes are levied or the taxable year to which the taxes relate. (A grandfathering rule for Article 17 (Professor) of the Current Tax Treaty will be provided.)

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