News Analysis: Japan-Saudi Arabia Tax Treaty Enhances Commercial Ties

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The Japan-Saudi Arabia double tax agreement -- signed in Tokyo on November 15 -- will provide greater certainty for taxpayers, further enhancing cross-border investment between the two nations. (For the English text of the treaty, see *Doc 2010-24904* or *2010 WTD 225-18*. For prior coverage, see *Doc 2010-24901* or *2010 WTD 224-9*.)

The DTA is Japan's second such agreement with a member of the Gulf Cooperation Council (GCC), the first being with Kuwait. Driven by a commitment to increase foreign direct investment**,** the Japanese government has been focusing on its trading partners in the Middle East. The government also plans to conclude treaties with Brunei and Kazakhstan and the other GCC member states -- Bahrain, Oman, Qatar, and the United Arab Emirates (with which it is now involved in DTA negotiations). Japan already has DTAs in place with Egypt, Israel, and Turkey.

Background -- Saudi Arabia and Japan

Japan has a close commercial relationship with Saudi Arabia. According to Saudi Arabia's General Investment Authority, Japan is the largest investor in Saudi Arabia and is the kingdom's third-largest trading partner. Moreover, Saudi Arabia exports the most oil to Japan of all the OPEC member nations and is Japan's fifth-largest trading partner, trailing only the United States, China, South Korea, and Thailand. Major Japanese multinational enterprises, such as Sumitomo Chemical and Mitsubishi Corp., maintain a strong commercial presence in Saudi Arabia involving the kingdom's energy and petrochemical industries.

Japan and Saudi Arabia have recently expressed a mutual desire to strengthen bilateral economic cooperation. During the 11th Japan-Saudi Arabia Business Council in February, Shigeru Endo, Japan's ambassador to Saudi Arabia, highlighted gains made in Saudi Arabia by Japanese companies outside of the energy sector. In June, Saudi Aramco and Japan's Ministry of Economy, Trade and Industry reached a deal that allows Saudi Aramco to store 3.8 million barrels of crude oil in Japan. The deal gives Saudi Arabia better access to the Asian market and bolsters Japan's crude oil reserves. In November, the two countries resolved to enhance cooperation in the field of atomic energy.

The conclusion of the Japan-Saudi Arabia DTA signifies a reaffirmation of the robust economic bonds between the two nations and will likely spur further cooperation and investment.

DTA Highlights

The major highlights of the DTA, particularly for Saudi Arabian residents investing in Japan, are the favorable withholding tax rates levied on dividend, interest, and royalty income. Japanese domestic tax law now levies a 20 percent withholding tax on this income.

Other benefits include clarity regarding the definition of a permanent establishment, the ability to claim a foreign tax credit in Japan on tax paid in Saudi Arabia, and mutual agreement procedures. An overview of the DTA's key provisions follows, with each provision discussed in the order in which it appears in the agreement. The terms "contracting state" and "other contracting state" mean Japan or Saudi Arabia, as the context requires.

Persons and Taxes Covered (Articles 1 and 2)

The DTA will apply to persons who are residents of Japan, Saudi Arabia, or both, a standard provision in Japan's recent DTAs. In the case of Japan, the DTA applies to income tax, corporate tax, and local inhabitants' taxes. For Saudi Arabia, it covers the Zakat (a religious levy on Saudi nationals and companies that are wholly owned by Saudi nationals) and income tax, including the natural gas investment tax.

Eligible Persons: Resident (Article 4)

Individuals

Under the DTA, a person is deemed to be a resident of a contracting state if, by reason of domicile or residence, that person is subject to tax in that contracting state. The DTA contains the standard tie-breaker provision for residents of both jurisdictions, with the competent authorities of each jurisdiction acting as final arbiters if required.

Corporations

A corporation is deemed to be a resident of Saudi Arabia if it is formed under the Saudi companies regulations or if its primary place of control and management is in Saudi Arabia. Under Japanese law, a corporation is a resident of Japan if its head or main office is in Japan.

If, under this criterion, a corporation can be deemed to be a resident of both contracting states, the corporation will be considered to be a resident of the contracting state in which its head office or place of effective management is situated.

Permanent Establishment (Article 5)

The definition of permanent establishment under the new DTA essentially follows the definition in the OECD model income tax treaty, which is in contrast to some of Japan's other recently negotiated DTAs (for example, the Australia-Japan DTA contains a broader PE definition).

Fixed Place of Business PE

The DTA contains the standard PE definition: a fixed place of business through which the business of an enterprise is wholly or partly carried on. The list of PE examples includes a place of management, a branch, an office, a factory, a workshop, and a place of extraction of natural resources.

Construction PE

The DTA mirrors Japanese domestic tax law in that it establishes a minimum period of six months before a construction site or installation project becomes a PE.

Agent PE

The agent PE concept under Japanese domestic tax law is quite broad, and it specifically includes agents that:

- habitually exercise authority to conclude contracts on behalf of a nonresident;
- negotiate important terms leading to the conclusion of contracts; or
- maintain sufficient goods to meet the requirements of a nonresident's customers and deliver the goods to the customers.

The DTA provides that a person other than an agent of independent status acting on behalf of a foreign enterprise that has -- and habitually exercises in a contracting state -- the authority to conclude contracts in the name of the enterprise will be a PE of the foreign enterprise. The DTA definition is narrower than Japan's domestic tax law definition, as it does not include filling orders or negotiating activities, as does Japan's domestic tax law definition.

Insurance PE

Interestingly, the DTA includes a provision stating that an insurance enterprise of a contracting state will be deemed to have a PE in the other contracting state if it collects premiums in that other contracting state or insures risks there.

PE Exemption -- Ancillary Activities

The PE provision also includes the standard list of activities that may be performed without creating a PE. These include:

- the use of facilities solely for storage, display, or delivery of goods or merchandise belonging to the enterprise;
- maintaining the goods or merchandise;
- maintaining goods for the purpose of processing by another enterprise;
- purchasing goods or collecting information; and

- any other activity that is preparatory in nature, or any combination of these activities, as long as the overall activity of the fixed place of business is preparatory or auxiliary in character.

The PE definition under the DTA will provide greater certainty regarding the scope of activities an agent is permitted to perform on behalf of a Saudi Arabian resident without creating a PE for the nonresident.

Business Profits (Article 7)

Japanese domestic tax law follows the force of attraction principle, meaning that if a nonresident has a PE in Japan, all of the nonresident's Japan-source income -- whether attributable to the PE or not -- is subject to Japanese corporate tax. Conversely, Saudi Arabia follows the profits attributable principle whereby only that portion of a nonresident's Saudi-source income derived from a PE situated in Saudi Arabia is subject to Saudi corporate tax. The Japan-Saudi Arabia DTA also follows the profits attributable principle, consistent with the OECD model.

The DTA also follows the standard OECD model provisions by which a PE's profits are calculated as if the PE were a separate and distinct entity operating under the same conditions. Also, relevant expenses associated with the PE's operations are deductible for the purposes of calculating the PE's business profits.

Transfer Pricing (Article 9)

The DTA contains standard OECD transfer pricing language, meaning that a tax authority may make an adjustment to a taxpayer's profits if it determines that a transaction with a related party was not conducted at arm's length. In this case, a corresponding adjustment to the related taxpayer's profits in the other contracting state will also be made.

Dividends (Article 10)

Under Japanese tax law, dividends paid by a Japanese company to nonresident shareholders (for example, residents of Saudi Arabia) are subject to withholding tax (WHT) of 20 percent (now reduced to 7 percent for listed companies until December 31, 2011, after which it will increase to 15 percent).

Under Saudi Arabia's domestic tax law, dividend payments from Saudi Arabian residents to nonresidents are subject to a WHT of 5 percent. Thus, this DTA provision is most relevant for dividends paid from a Japanese company to a Saudi Arabian resident.

Under the DTA, beneficial owners holding at least 10 percent of the voting power of the dividend-paying company will be able to take advantage of a 5 percent withholding rate; in all other cases, the WHT will be 10 percent.

Interest (Article 11)

Under Japanese domestic tax law, interest payments paid to a nonresident are subject to 20 percent WHT rate (15 percent for bonds).

Under Saudi Arabia's domestic tax law, interest payments made to nonresidents of Saudi Arabia are subject to a 5 percent WHT. Again, this section is most relevant for interest paid by a Japanese company to a Saudi Arabian resident shareholder.

Under the DTA, no WHT will be assessed on interest paid to the government of either Japan or Saudi Arabia, the central bank of either nation, or any institution wholly owned by either government. Moreover, income from debt claims arising in a contracting state will not be subject to WHT if the income is beneficially owned by a resident of the other contracting state where the debt claims are guaranteed, insured, or indirectly financed by the government. In all other cases, the WHT on interest will not exceed 10 percent.

An antiabuse provision is included to prevent taxpayers from charging excessive interest on intercompany debt financing arrangements. In these cases, any excessive interest can be taxed by the source country under its domestic tax law.

Royalties (Article 12)

Under Japanese domestic tax law, royalties paid to nonresidents are subject to a WHT of 20 percent. Saudi Arabian domestic tax law assesses a WHT rate of 15 percent on royalties paid to nonresidents.

The DTA provides for a more favorable WHT rate structure. Under the DTA, royalties paid by a resident of a contracting state to a resident of the other contracting state for the use of -- or right to use -- industrial, commercial, or scientific equipment will not be subject to a WHT rate greater than 5 percent. In all other cases, the WHT rate is not to exceed 10 percent.

The DTA defines a royalty as a payment of any kind received as consideration for the use of, or right to use, any copyright of literary, artistic, or scientific work, including motion pictures and films or tapes used for radio or television broadcasting; any patent, trademark, design or model, plan, or secret formula or process; any industrial, commercial, or scientific equipment; or information concerning industrial, commercial, or scientific experience.

An antiabuse provision identical to the one contained in the interest article (see above) is included. If an excessive royalty rate is charged on an intercompany arrangement, the excessive portion of the royalty can be taxed by the source country under its domestic tax law.

Capital Gains (Article 13)

Under current Japanese domestic law, a gain realized by a Saudi Arabian resident through the alienation of shares in a Japanese company will be subject to Japanese tax if:

- the Saudi Arabian resident (including affiliates) has, at any time in the preceding three years, held 25 percent or more of the shares in the company and sells 5 percent or more of its shares in the current year;
- at least 50 percent of the company's assets consist of real property; or
- the nonresident gains from a greenmailing[1] transaction.

Further, any gains realized from the alienation of real property located in Japan will be subject to tax in Japan.

Generally speaking, Saudi Arabia treats capital gains as ordinary income, subject to taxation at regular corporate rates. However, gains derived by non-Saudi shareholders from the sale of shares in a Saudi company traded on the Saudi stock exchange are exempt from tax if the shares were acquired after July 30, 2004. Gains from the alienation of property other than property used in the course of business are also exempt from tax.

Under the DTA, capital gains derived by a resident of one of the contracting states through the alienation of real estate located in the other contracting state may be taxable in the other contracting state. Similarly, gains realized by a resident of a contracting state on the sale of shares in a company that derives at least 50 percent of its value from real estate located in the other contracting state are taxable in that other contracting state.

The DTA also confirms that gains realized by a resident of a contracting state from the alienation of shares issued by a company that is a resident of the other contracting state will be taxable in that other contracting state if the alienating resident, along with related parties, owned at least 25 percent of the total issued shares of the company at any time during the taxable year in which the shares were alienated.

Gains made by an enterprise of a contracting state on the alienation of property, other than real property, associated with a PE that the enterprise maintains in the other contracting state are taxable in that other contracting state. However, gains from the alienation of any other property not addressed by article 13 will be taxable only in the contracting state where the alienator resides.

Income from Independent Personal Services (Article 14)

Income derived by a resident of a contracting state from the performance of professional services or other activities of an independent character in the other contracting state will be taxable in that other contracting state only if the resident has a fixed base regularly available to him in the other contracting state for the performance of his activities or the resident is present in the other contracting state for a period or periods amounting to or exceeding, in the aggregate, 183 days in any 12-month period commencing or ending in the taxable year concerned.

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[1] Buying a sufficient amount of a company's stock to threaten a hostile takeover and then reselling the stock to the company at a price exceeding market value.

Moreover, the DTA specifies that the other contracting state may tax only that portion of the resident's income that is attributable to its fixed base in the other contracting state or its presence in the other contracting state in accord with the 183-day rule. In other words, if, for example, a resident of one contracting state performs professional services in the other contracting state for 183 days, the other contracting state may tax only that portion of the resident's income attributable to its 183rd day of work.

Income from Dependent Personal Services (Article 15)

Under Japanese domestic law, a nonresident individual who performs business activities in Japan (even if for only one day) is required to file an individual tax return and is subject to a 20 percent tax on the gross amount. The DTA, however, provides relief from taxation if the three conditions of the standard 183-day rule are satisfied. The 183-day rule states that employment income earned by an individual resident in one of the contracting states will be taxable in the other contracting state only if:

- the recipient is present in the other contracting state for a period or periods not exceeding, in the aggregate, 183 days in any 12-month period commencing or ending in the taxable year concerned;
- the remuneration is paid by, or on behalf of, an employer who is not a resident of the other contracting state; and
- the remuneration is not borne by a PE that the employer has in the other contracting state.

This will be a much-welcomed change for Saudi Arabian companies that have to send employees to Japan to work with customers there.

Other Income (Article 22)

A provision commonly found in Japan's DTAs is the "other income" article. Items of income of a resident of a contracting state that are not specifically addressed by the DTA and that arise in the other contracting state are taxable in that other contracting state. Specifically, if a resident of a contracting state carries on business in the other contracting state through a PE there, the "other income" that is effectively connected to the PE is taxable in that other contracting state.

Elimination of Double Taxation (Article 23)

The DTA provides relief from double taxation, albeit with the adoption of different approaches, depending on whether a resident of Japan or Saudi Arabia is involved. When a resident of Japan derives income from Saudi Arabia, the amount of Saudi tax payable on that income will be allowed as a credit against Japanese tax imposed on the resident. When a resident of Saudi Arabia derives income from Japan, the Saudi authorities will allow that resident to claim a tax deduction in an amount equal to the tax paid in Japan.

Limitation on Relief (Article 24)

Interestingly, the DTA does not contain a limitation on benefits provision, which is common in a number of DTAs Japan has recently concluded. However, it does contain a limitation on relief (LOR) article, which is an antiabuse measure.

While not containing the same requirements as found in a typical LOB provision, the LOR provision simply states that relief will be unavailable for reduced WHT rates on interest, dividends, and royalties and favorable tax treatment of capital gains and other income (explained above) if the main purpose, or one of the main purposes, of the contemplated structure or transaction from which the income arises is to take advantage of the favorable tax treatment afforded under the DTA.

The recently concluded Hong Kong-Japan DTA contains a similar provision.

Mutual Agreement Procedure (Article 25)

A significant benefit arising under the Japan-Saudi Arabia DTA is taxpayers' ability to present their cases to the competent authority so that it may, on the taxpayer's behalf, resolve the issue with the competent authority of the other contracting state. No such mechanism exists under Japanese domestic tax law, and as the number of high-profile transfer pricing cases continues to increase, the ability to resolve disputes at the competent authority level offers taxpayers additional protection.

Under the DTA, the taxpayer must present its case within three years from the first notification of the action resulting in taxation that is not in accordance with the DTA.

Exchange of Information (Article 26)

Under the DTA, the competent authorities of Japan and Saudi Arabia will exchange information as required in order to carry out the provisions of the DTA or for the purposes of enforcing their own domestic tax laws.

The DTA stipulates that any information received by a contracting state will be treated as secret in the same manner as information obtained under the domestic laws of that contracting state. This information is only to be disclosed to persons or authorities (including courts and administrative bodies) concerned with the collection, enforcement, prosecution, or appeal relating to taxes applicable in the contracting state. These persons or authorities will use the information only for such purposes but may disclose the information in public court proceedings or in judicial decisions.

Entry Into Force (Article 29)

The DTA will enter into force on the first day of the second month following the exchange of diplomatic notes by the Japanese and Saudi governments advising that the constitutional processes required for entry into force have been completed. For both Japan and Saudi Arabia, the DTA will have effect on or after January 1 of the calendar year following the year in which the agreement enters into force.

Implications

During the 11th Japan-Saudi Arabia Business Council, Japan's ambassador to Saudi Arabia said Japan's business and economic ties with Saudi Arabia would be enhanced and broadened through the implementation of a GCC-Japan free trade agreement, a bilateral investment agreement with Saudi Arabia, and the conclusion of a tax treaty with Saudi Arabia. The Japan-Saudi Arabia DTA represents a marked step in this direction. Given Japan's technological expertise and resource needs and Saudi Arabia's resource-rich territory and infrastructure needs, the two nations are natural economic partners.

Moreover, the Japan-Saudi Arabia DTA can be viewed not only as an affirmation of Japan's commercial relations with Saudi Arabia, but also as evidence of Japan's resilient interest in the region, given its recently enacted DTA with Kuwait and its ongoing negotiations with the U.A.E. Many finance commentators agree that it is critical that Japan make the execution of DTAs with Middle Eastern countries a priority to encourage capital inflow into the country. Likewise, the Middle East understands the benefits of having treaties with Japan. Japanese investment in the Middle East continues to grow, and developing a treaty network will result in a further increase in the number and size of investments being made in the Middle East region.

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