

**TAX TREATY TREATMENT OF TAX CREDITS WHEN MOVING FROM A  
CREDIT TO AN EXEMPTION SYSTEM  
FOR MSSRS. THOMAS & EDGE**

**Submitted by Chairman Dave Camp**

Concerns have been raised about the status of the United States' tax treaty network if the United States moves from an international tax system that allows a tax credit to be taken for foreign income taxes paid, to a system that exempts certain dividends paid by foreign subsidiaries from taxation. As with many countries that tax worldwide income, U.S. tax treaties generally state that the U.S. will provide a credit against foreign income taxes. The Committee, however, is considering whether the U.S. should move to a system that provides an exemption for certain dividends paid by foreign subsidiaries, in lieu of a foreign tax credit. How did your country deal with its tax treaties when moving from a credit to an exemption system? Was this discussed, or will your tax treaties need to be renegotiated?

**Responses Concerning Japan  
from Gary M. Thomas**

1. In brief, Japan takes the position that provisions in a tax treaty concerning foreign tax credits (including direct foreign tax credits and indirect foreign tax credits) are subject to the foreign tax credit rules in effect under its domestic tax law from time to time. Consequently, neither the elimination of the direct foreign tax credit for withholding taxes imposed on dividends from foreign subsidiaries which are exempt under the new foreign dividend exemption system nor the abolishment of the indirect foreign tax credit rules under Japanese domestic tax law were viewed as creating any requirement to renegotiate Japan's tax treaties.

2. Japan's tax treaties typically contain a clause concerning foreign tax credits which reads as follows:

“(S)ubject to the provisions of the laws of Japan regarding the allowance as a credit against the Japanese tax of tax payable in any country other than Japan:

(a) Where a resident of Japan derives income from the [Treaty Country] which may be taxed in the [Treaty Country] in accordance with the provisions of this Convention, the amount of the [Treaty Country] tax payable in respect of that income shall be allowed as a credit against the Japanese tax imposed on that resident. The amount of the credit, however, shall not exceed that part of the Japanese tax which is appropriate to that income.

(b) Where the income derived from the [Treaty Country] is dividends paid by a company which is a resident of the [Treaty Country] to a company which is a resident of Japan and which owns not less than [10 or 25] percent of the voting

- shares issued by the company paying the dividends during the period of six months immediately before the day when the obligation to pay dividends is confirmed, the credit shall take into account the [Treaty Country] tax payable by the company paying the dividends in respect of its income.
3. Several treaties contain foreign tax credit clauses which refer solely to direct foreign tax credits and do not mention indirect foreign tax credits.
  4. The “provisions of the laws of Japan regarding the allowance as a credit against the Japanese tax of tax payable in any country other than Japan” are found (with respect to corporations) in the foreign tax credit system in the Corporation Tax Law, comprised of both direct foreign tax credit rules and, prior to 2009, indirect foreign tax credit rules.
  5. Upon the adoption of the foreign dividend exemption system, Japan amended its foreign tax credit rules as follows:
    - (a) the indirect foreign tax credit rules were abolished (subject to certain transition provisions), and
    - (b) direct foreign tax credits were denied for foreign taxes imposed on dividends paid by foreign subsidiaries which are subject to the dividend exemption
  6. Direct foreign tax credits continue to be allowed for foreign taxes imposed on dividends paid by foreign subsidiaries which are not subject to the dividend exemption.
  7. The clear position in Japan concerning the relationship between a tax treaty and domestic tax law with regard to foreign tax credits is that, because the treaty contains the language “(s)ubject to the provisions of the laws of Japan regarding the allowance as a credit against the Japanese tax of tax payable in any country other than Japan,” in principle, no restrictions are imposed upon Japan under such foreign tax credit clause in a tax treaty regard to the contents of its foreign tax credit system in domestic tax law.
  8. Consequently, there was considered to be no need to renegotiate Japan’s existing treaties due to the adoption of the foreign dividend exemption system which was accompanied by modifications to the foreign tax credit system in domestic tax law. New treaties simply do not include any reference to indirect foreign tax credits.
  9. Nevertheless, there was a concern for ensuring that the benefit of avoiding double taxation (albeit, through the foreign dividend exemptions rather than the foreign tax credit system) would be extended to dividends that had earlier been subject to the indirect foreign tax credit under treaties. Consequently, the 25% minimum shareholding threshold for applying the foreign dividend exemption is reduced to whatever ratio is set forth in a pertinent tax treaty for application of the indirect foreign tax credit system. Thus, for examples, dividends received by a Japanese parent company from a United States company in which it holds at least 10% of the shares will be subject to the foreign

dividend exemption. Treaty requirements for qualifying for the reduced shareholding ratios will be applied when making this determination.

10. Finally, Japan also adopts in principle the notion that taxpayers are allowed to elect to apply the more favorable of treaty rules or domestic tax law rules. However, notwithstanding that some taxpayers in limited circumstances might find the prior foreign tax credit rules to be preferable to the foreign dividend exemption system, the above-mentioned principle is not considered to apply in this kind of situation. Nevertheless, transition rules allow taxpayers to elect to continue to apply the indirect foreign tax credit rules to a limited extent after the adoption of the new rules.

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