

# Japan Tax Bulletin

## Withholding on royalties paid to Nonresidents or Foreign Corporations

**November 2022**

When royalties are paid to nonresidents or foreign corporations, withholding tax is generally imposed on the income. The withholding tax on such royalties, may be reduced or exempted by applying a tax treaty, but there are some points that require attention regarding the application and procedures.

### 1. Definition of royalties

Under Japan income tax law, royalties that require withholding are defined as follows:

(a) Royalties for an industrial property right or any other right to the use of technology, a production method based on special technology, or any equivalent right or method; or consideration for the transfer thereof;

(b) Royalties for a copyright (including print rights, neighboring rights, and any equivalent rights), or consideration for the transfer thereof;

(c) Royalties for machinery, equipment, or any other tool prescribed by Cabinet Order.

In addition, the OECD Model Tax Convention defines royalties as follows:

- The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

### 2. Withholding tax on royalty payments to nonresidents and foreign corporations

#### 2.1 Treatment under Japan income tax law

Under domestic law, with respect to royalties paid in Japan to nonresidents or foreign corporations, if the royalties are domestic source income, withholding tax is imposed at a rate of 20.42% of the royalty.

#### 2.2 Treatment under tax treaties

Tax treaties concluded with countries around the World set lower withholding tax rates than those under Japan's domestic tax law. If a tax treaty is applicable and advantageous treatment

can be obtained by applying the treaty, the withholding tax amount can be reduced or exempted by submitting an "Application Form for Income Tax Convention (Form 3), etc.

### 3. The source rules for royalties

Withholding at source is applicable when the royalty is domestic source income. In determining whether a royalty fee constitutes domestic source income, there are two different approaches: the "place of use principle" and the "debtor's principle". It is important to keep in mind the difference between the two.

The "place-of-use" principle holds that the source of income is the country in which the right or asset from which the royalty is derived is actually being used. If the rights or assets from which the royalty is derived are used in Japan, the royalty is domestic source income and subject to withholding at source. Domestic laws adopt this "place of use principle. Royalties are treated as domestic source income if they are paid in relation to payer's domestic businesses. It is generally construed that the domestic law employs "place-of-use" principle.

On the other hand, the "debtor principle" is based on the concept that the place of residence of the payer of the royalty fee is the source of income for that fee. In other words, royalties paid by a Japan corporation are domestic source income and subject to withholding. It does not matter where the rights or assets were used. Most tax treaties adopt this "debtor principle.

It is generally easier to identify the place of income source under debtor principle than place of use principle.

On the other hand, where a Japanese corporation has a license agreement with a foreign corporation under which the Japanese corporation is granted to exploit industrial property rights the foreign corporation owns and sublicenses them to a foreign subsidiary for its business in a foreign country, royalties related to the sublicense to the foreign subsidiary which are paid to the foreign licensor are not subject to Japan withholding under place of use principle. Place of use principle is useful to eliminate international multi-level taxation.

If a tax treaty provides for different rules for domestic source income than domestic law, Japanese law provides as follows;

-Notwithstanding the preceding Article, if a convention that Japan has concluded for the avoidance of double taxation with respect to taxes on income contains provisions on domestic

source income which differ from the provisions of the preceding Article, the domestic source income of a person subject to such a convention is governed by that convention, to the extent of the differing provisions.

Therefore, if a tax treaty provides for different rules for domestic source income from those under domestic law, the rules based on the tax treaty will apply.