Japan Tax Bulletin

Change in Interpretation of Tax Convention by the National Tax Agency

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The National Tax Agency (NTA) in Japan announced on 30 March 2023 a change in interpretation of "the end of the accounting period for which the distribution of profits takes place" under (Article 10, Japan-Luxembourg Tax Convention (JLTC)), following a case determined by the Tokyo High Court on 16 February 2023.

1. *Summary of the case*

Company X, a foreign company whose head office was in the Grand Duchy of Luxembourg, acquired 100% of the shares of Company A and Company B, which were both Japanese companies, on 29 April 2014. Company A and Company B sold a part of their businesses to other Japanese companies on 1 August 2014 by a Non-Qualified Business Split-off (NQBS), a type of organization restructuring in Japan, where Company A and Company B sold a part of their businesses in exchange for interests in recipient companies and distributed them to Company X. Namely, Company X received consideration which was partly recognized as dividends ("deemed dividends" in this context) by the NQBS. The amount of the deemed dividends was approximately JPY14 billion and Company X paid withholding tax of 20.42%, around JPY2.8 billion, under the Income Tax Act in Japan. Soon after Company X found out that the applicable tax rate for the deemed dividends could be reduced to 5% under Art. 10-2-a of JLTC, and Company X claimed a tax refund of about JPY2.1 billion. However, since the NTA only gave around JPY700 million back to Company X, assuming that the applicable tax rate could be reduced only to 15% for the deemed dividends under Art. 10-2-b of JLTC, it resulted in a court case.

According to Art. 10-2-a of JLTC:
The applicable tax rate is 5%, in the case where a beneficiary owns at least 25% of voting shares for 6 months before the end of the accounting period for which the distribution of profits takes place.

According to Art. 10-2-b of JLTC:
The applicable tax rate is 15% for all cases other than the cases described in Art. 10-2-a of JLTC.

2. *Issue*

The issue of this case is interpretation of "the end of the accounting period for which the distribution of profits takes place". Company X claimed that the end of the fiscal year that included the date of the distribution of deemed dividends should be recognized as "the end of the accounting period for which the distribution of profits takes place" and it had owned the shares of Companies A and B for more than 6 months at that point. On the other hand, the NTA claimed that the day before the date of the NQBS is recognized as "the end of the accounting period for which the distribution of profits takes place" and Company X had not owned the shares of Companies A and B for 6 months at that date.

3. *Judgement*

The Tokyo High Court judged that "the end of the accounting period for which the distribution of profits takes place" under Art. 10-2-a of JLTC should be interpreted based on Art. 3-2 of JLTC, which states that terms which are not defined in JLTC are regarded to have the definition of the terms as defined in the country where JLTC is applied. In addition, the court also judged that "the end of the accounting period for which the distribution of profits takes place" means an accounting period that included the date of the distribution of deemed dividends as an ordinary meaning in terms of intents and purposes under Japanese law. In that context, Company X owned the shares of Companies A and B for more than 6 months. Therefore, the court has adopted Company X's claim and Tokyo High Court has made the same decision.

4. *Announcement by the NTA*

In response to the defeat in court, the NTA announced a change in interpretation of "the end of the accounting period for which the distribution of profits takes place" under JLTC on 30 March 2023. Previously, in the case of a deemed dividend on the basis of an NQBS, the day before the NQBS was conducted was used as the end of the accounting period for which the distribution of profits takes place under JLTC. However, in response to the judgement, the NTA has changed its interpretation to treat the end of the fiscal year which includes the date of the NQBS as the end of the accounting period for which the distribution of profits takes place under JLTC. Also, the same treatment has been applied to deemed dividends from the acquisition of treasury stock. This change by the NTA is applied retroactively. Therefore, if the withholding tax is excessive as a result of a reassessment of the holding period requirements, a retroactive tax refund could be claimed unless the withholding tax was paid more than 5 years ago.

5. Application of the case in practice

Similar provisions to this one are contained in tax conventions with the following countries: Israel, Italy, Indonesia, Austria (until payments made before December 31, 2018), Canada, Singapore, Spain (until payments before December 31, 2021), Thailand, Korea, Denmark (until payments before December 31, 2018), Turkey, Norway, Bangladesh, Finland, Bulgaria, Malaysia, Luxembourg, South Africa, and Mexico.