TECHNICAL EXPLANATION OF THE
UNITED STATES-JAPAN INCOME TAX CONVENTION

GENERAL EFFECTIVE DATE UNDER ARTICLE 28: 1 JANUARY 1973

It is the practice of the Treasury Department to prepare for the use of the Senate and other interested persons a Technical Explanation of the tax conventions which are submitted to the Senate for it advice and consent to ratification.

A new Income Tax Convention with Japan was signed March 8, 1971, and submitted by the President to the Senate on May 11, 1971. The Senate committee on Foreign Relations held hearings on November 19, 1971, and this Technical Explanation was submitted on February 13, 1973. The Senate voted its advice and consent on November 29, 1971, and instruments of ratification were exchanged on June 9, 1972, the Convention thereby entering into force on the thirtieth day thereafter, July 9, 1972. The provisions of the Convention generally became effective for taxable years beginning on or after January 1, 1973.

TABLE OF ARTICLES

ARTICLE 1
Taxes Covered

This article designates the taxes of the respective States which are the subject of the Convention. With respect to the United States, the taxes included are the United States Federal income tax imposed by the Internal Revenue Code. This includes, for example, the surtax and would also include such taxes as the temporary surcharge which was in force from 1968 to 1970. However, the Convention does not, in general, apply to taxes which are in the nature of a penalty such as the taxes imposed under section 531 (accumulated earnings tax) and section 541 (personal holding company tax) of the Internal Revenue Code (see, however, paragraph (6) of Article 4 and Articles 7 and 26).

With respect to Japan, the taxes included are the income tax, imposed on individuals, and the corporation tax (as modified by the Special Taxation Measures Law and other special laws which provide for special measures applicable to taxpayers in Japan).

The Japanese income tax is imposed upon resident individuals at graduated rates. There are two categories of residents for this purpose. Except in the circumstances described in the next sentence, an individual who either has a domicile in Japan or has a residence in Japan for one year or more is treated as a resident. Unless he is a nonpermanent resident he is taxed on his worldwide income. An individual who has no intention of residing in Japan permanently is treated as a nonpermanent resident if he has had residence or domicile in Japan for an uninterrupted period of not more than 5 years. A nonpermanent resident is taxed only on income derived from sources within Japan and on income derived from foreign sources which is paid in or remitted to Japan. An individual who has no domicile in Japan and is either not resident in Japan or has had residence there for less than one year is treated as a nonresident and is taxed solely upon income from sources within Japan. In the case of income attributable to a Japanese business, the nonresident is subject to tax at graduated rates on a net income basis. However, in calculating net income for this purpose, the nonbusiness deductions, exemptions, and tax credits allowed (for a nonresident) are limited to the deduction for casualty losses on assets situated in Japan, the basic exemption, and credits for dividends and for contributions. In the case of Japanese source nonbusiness income, received by a nonresident of Japan, a flat rate of 20 percent is applicable to the gross amount of passive income such as dividends, interest, royalties and annuities.

The Japanese corporate tax rate is 36.75 percent on undistributed profits and 26 percent on distributed profits. A foreign corporation is taxed at the higher rate on income which is derived from sources within Japan and attributable to business conducted in Japan through a permanent establishment. However, the rate on undistributed profits of Japanese corporations and on profits of foreign corporations is 28 percent (22 percent on distributed profits of Japanese corporations) if the corporations annual income is not in excess of 3 million yen and the capital is 100 million yen or less. Taxable income of a foreign corporation is computed generally in the same manner as taxable income of a domestic corporation.

Income of a foreign corporation without a permanent establishment in Japan derived from sources in Japan is taxed on a flat rate of 20 percent on gross amount of passive income such as dividends, interest, rents and royalties. (This 20 percent flat rate also applies to the Japanese source income of certain types of foreign corporations with permanent establishments if the income is not attributable to the permanent establishment.)

In addition to the taxes described above, prepayment of tax in the form of withholding is generally required by Japanese law. In the case of a resident individual (including a nonpermanent resident), tax is withheld at the source of interest income, original issue discount on bonds bearing no interest, dividend income, employment income, retirement income, and remuneration or lump sum payments for certain personal services. In the case of a nonresident individual or a foreign corporate of 20 per cent on certain income derived from sources in Japan, including dividends, interest on certain loans, rent for the use of immovable property, and royalties. An exemption from such withholding can be obtained if the taxpayer has a permanent establishment in Japan. However, the exemption does not extend to dividends or interest on loans.

Pursuant to paragraph (2) of this article, the Convention also applies to taxes substantially similar to those enumerated which are imposed, in addition to or in place of the existing income taxes, after the date of signature of the Convention, March 8, 1971.

For purposes of Article 7 (relating to nondiscrimination), the Convention applies to taxes of every kind which are, or may be, imposed in the respective States, at the National, State or local level. For purposes of Article 26 (relating to exchange of information), the Convention applies to taxes of every kind which are, or may be, imposed by the respective States at the National level. Thus, the United States will be able to obtain information with respect to the Interest Equalization Tax.

ARTICLE 2
General Definitions

This article sets out definitions of certain of the basic terms used in the Convention. A number of important terms, however, are defined elsewhere in the Convention.

Any term used in the Convention which is not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of the State which is imposing the tax. However, in a case where a term has a different meaning under the laws of Japan and the United States or where the meaning under the laws of one or both of the States is not clear, the competent authorities may agree on a uniform definition. This is made clear in paragraph (2)(d) of Article 25 (relating to the mutual agreement procedure). While treaties in the past did not specify the power of the competent authorities-to resolve such differences in definitions, this power is nevertheless inherent in the authority set forth in the mutual agreement article of these treaties to resolve "difficulties or doubts".

This article defines geographical Japan to include all the territories in which the laws relating to Japanese tax are in force. The geographical United States is defined to mean the states thereof and the District of Columbia.

The terms “a Contracting State” and "the other Contracting State" are defined to mean the United States or Japan, as the context requires. Although the term "State" is not specifically defined, it means a National State, whether or not it refers in context to one of the Contracting States.

A Japanese corporation is defined as being a juridical person which has its head or main office in Japan. All corporations incorporated in Japan are required to have their head office in Japan.

ARTICLE 3
Fiscal Domicile

This article sets forth rules for determining the "residence" of individuals, corporations and other persons for purposes of the Convention. Residence is important because, in general, only a resident of one of the Contracting States may qualify for the benefits of the Convention. This article is patterned generally after the fiscal domicile article of the OECD Model Convention.

The term "a resident of Japan" means a Japanese corporation as defined in Article 2 (relating to general definitions) and any other person who is a resident of Japan for purposes of its tax. The term "a resident of the United States" means a United States corporation as defined in Article 2 and any other person (except a corporation or any other entity treated as a corporation for United States tax purposes) resident in the United States for purposes of its tax. The parenthetical language in the definition of a resident of the United States is intended to make clear that a foreign corporation which is engaged in trade or business in the United States and which as a result is treated as a resident foreign corporation for certain purposes of United States income tax law is not) under the Convention, a resident of the United States. Such clarifying parenthetical language was unnecessary in the case of Japan, because Japan does not treat foreign corporations as Japanese residents for any tax purpose (although foreign corporations having a permanent establishment in Japan are taxed differently from those not having a permanent establishment in Japan).

The Convention provides in the case of the United States, that an estate or trust is treated as a resident with respect to income it receives only to the extent that such income is subject to United States tax as the income of a resident. Under United States law, a partnership is never, and an estate or trust is often not taxed as such. Under the Convention, in the case of the United States, income received by an estate or trust will not qualify for the benefits of the Convention unless such income is subject to tax in the United States. Thus, the status of income which is subject to tax only in the hands of the beneficiaries will be determined by the residence of such beneficiaries. With respect to income taxed in the hands of the estate or trust, the residence of the estate or trust is determinative. This provision is non-reciprocal because of the absence of a similar problem under Japanese law. Partnerships are not specifically included in the provisions, since the income of a partnership is subject to tax only in the hands of the partners and, thus, it is clear that for treaty purposes the residences of the partners are relevant with respect to income derived by the partnership rather than the residence of the partnership.

An individual who is a resident of both States under the rules of domestic law employed by such States for determining residence will be deemed a resident of the Contracting State in which he has his permanent home, his center of vital interests (closest economic and personal relations), his habitual abode, or his citizenship, in the order listed. If the issue is not settled by these tests, the competent authorities will decide by mutual agreement the one State of which he will be considered to be a resident.

An individual who is deemed to be a resident of one Contracting State by reason of Article 3 (3) will be deemed to be a resident of only that State for all purposes of the Convention, including the savings clause of Article 4 (3). For example, even if an individual treated as a resident of Japan under the Convention is also considered to be a resident of the United States under the laws of the United States, such individual would continue to receive the exemptions and special benefits available only to Japanese residents) assuming he is not a citizen of the United States.

ARTICLE 4
General Rules of Taxation

The general rules of taxation applicable under the Convention are as follows:

A resident of one State may be taxed by the other State only on in come from sources within that other State (including industrial or commercial profits attributable to a permanent establishment located in that other State), subject to the limitations set forth in the Convention. For this purpose, the source rules contained in Article 6 of the Convention are to be applied. The jurisdictional rules of the Convention parallel those set forth in section 872 (a) of the United States Internal Revenue Code, relating to nonresident alien individuals, and section 882 (b), relating to foreign corporations, as amended by the Foreign Investors Tax Act of 1966 [1966-2 C.B. 656].

The Convention continues the general rule (also found in our new Belgian, French, Finnish, Norwegian and Trinidad and Tobago conventions) that the Convention will not affect in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by' the laws of a State in the determination of a tax imposed by that State, or by any other agreement between the Contracting States. This rule represents the position of the United States under all conventions to which it is a party.

The Convention also contains the traditional savings clause under which each Contracting State reserves the right to tax its residents as if the Convention had not come into effect. In the case of the United States, the savings clause also applies to its right to tax its citizens. However, the savings clause does not apply in several specified cases in which its application would contravene policies reflected in the Convention. Thus, the savings clause does not affect the benefits relating to relief from double taxation (Article 5), nondiscrimination (Article 7), governmental functions (Article 21) or the mutual agreement procedure (Article 25). Moreover, the savings clause will not cause the benefits of the Convention to be denied to teachers and researchers (Article 19) or to students or trainees (Article 20) or those arising under Article 22, relating to rules applicable to the personal income articles, except, in the case of such benefits conferred by the United States, the benefits will be denied if such individuals are citizens of the United States or have immigrant status in the United States. In addition, the savings clause does not affect Article 24, which recognizes the fiscal privileges of diplomatic and consular officials.

Another general rule of taxation is that there shall be allowed, for purposes of the United States tax in the case of a resident of Japan who is not a resident of the United States (other than an officer or employee of the Japanese government or local authority thereof), in addition to the deduction for one personal exemption provided in section 873 of the Internal Revenue Code as in effect on December 1, 1968, a deduction for personal exemptions, subject to the conditions prescribed in sections 151 through 154 of the Internal Revenue Code as in effect on December 1, 1968, for the spouse and each child of the taxpayer present in the United States and residing with him in the United States at any time during the taxable year. Reference is made to sections 151 through 154 for purposes of setting forth the conditions of obtaining the deduction. The amount of the deduction is determined on the basis of the amount of the exemption taxed in the Internal Revenue Code for the taxable year. However, the taxpayer is not entitled by reason of the Convention to the additional exemptions for age and blindness. The amount of the additional deduction provided by the Convention is the proportion of the exemption fixed by the Internal Revenue Code which the taxpayer's gross income from sources within the United States which is treated as effectively connected with the conduct of a trade or business within the United States within the meaning of section 864 (c) of the Internal Revenue Code of 1954 for the taxpayers taxable year bears to his entire income from all sources for such taxable year. Article XVI (1) of the 1954 Convention with Japan provided substantially the same exemptions as the new Convention. However, under the 1954 Convention the limitation on the additional deduction for the taxpayer's spouse and children provided that the deduction could not exceed the proportion thereof which the taxpayer's entire gross income from sources within the United States for his taxable year bore to his entire income from all sources for the fiscal or calendar year in which such taxable year ended. The taxpayer's own personal exemption is not limited under either Convention.

In this article, the United States also reserves the right to impose its personal holding company tax in any taxable year except in cases in which a Japanese corporation is wholly owned, directly or indirectly, by one or more individuals who are residents of Japan, and not citizens of the United States, for that entire taxable year. The United States may not impose its accumulated earnings tax in any taxable year on a Japanese corporation unless such corporation is engaged in trade or business in the United States through a permanent establishment at some time during that taxable year. The limitations on the right of the United States to tax do not expand upon the limitations now found in the Internal Revenue Code.

This Article also contains the rule that whenever any provision of the Convention provides for a State to reduce the rate of tax on, or exempt the income of, a resident of the other State and such resident is subject to tax by that other State, the reduction or exemption shall apply only to so much of such income as is remitted to or received in that other State. Under Japanese law, a person who is a nonpermanent resident of Japan is only taxed on income derived from sources within Japan and on income from other sources which is remitted to or received in Japan. Consequently, that person should not be able to avail himself of the benefits of the Convention to the extent his income is not currently taxed by Japan.

ARTICLE 5
Relief from Double Taxation

Under the 1954 Convention, the United States provided relief from double taxation by allowing a credit for Japanese tax in accordance with the provisions of the law of the United States and, accordingly, incorporated by reference the foreign tax credit provision of the 1939 Code (section 131)

The new Convention employs the same method of avoiding double taxation in providing that in accordance with the provisions of the law of the United States (as in force from time to time) credit will be allowed for the appropriate amount of Japanese tax payable by a citizen or resident of the United States. Except for the special source rules provided by the Convention, this provision does not add to the rights which a United States citizen or residence has to the foreign tax credit as now in effect, but is for the purpose of giving treaty recognition to such rights. Modifications in United States law after the effective date of the Convention which concern the foreign tax credit will be applicable with respect to Japanese source income if such modifications do not contravene the general principle of the Convention. In addition to the credit mentioned above in this paragraph, a United States corporation owning at least 10 percent of the voting power of a Japanese corporation from which it receives dividends in a taxable year will be allowed a credit for the appropriate amount of Japanese tax paid by the Japanese corporation paying such dividends with respect to the profits out of which such dividends are paid. The rules set forth in Article 6 (source of income) are available to determine the source of income for the purpose of applying the United States credit in relation to taxes paid to Japan.

In the case of Japan, the Convention employs a credit method for avoiding double taxation similar to that provided in the case of the United States.

Paragraph (2) of this article provides that any tax on income or profits imposed by a political subdivision or local authority of a State shall be included along with the tax of that State which will be credited by the other State.

ARTICLE 6
Source of Income

This article sets forth in a single provision, as in the 1954 Convention, the rules which are to be applied to determine the source of the different kinds of income covered by the Convention: dividends, interest, royalties, income from real property (including gains derived from the sale of such property), income from the rental of tangible persona] property, compensation for personal services, and income from the purchase and sale of personal property and industrial or commercial profits. In addition to the articles dealing with specific types of income, these rules affect the application of Article 4 (relating to general rules of taxation) and Article 5 (relating to relief from double taxation).

The source of any kind of income not covered by the Convention is to be determined under the internal law of the two States. In the case of different source rules applicable to an item of income, the competent authorities of the two States under the mutual agreement procedure may establish a common source for the item of income. This is made clear in paragraph (2)(c) of Article 25 (relating to the mutual agreement procedure).

Dividends will be treated as income from sources within a State only if paid by a corporation of that State.

Interest will be treated as income from sources within a State only if paid by that State, or by a political subdivision, local authority, or resident of that State. However, there are two situations relating to interest paid on indebtedness (other than interest incurred in connection with the purchase of ships or aircraft) where this general rule does not apply. The general rule does not apply, regardless of the residence of the person paying the interest, if the person paying the interest has a permanent establishment in either Contracting State in connection with which the indebtedness on which the interest is paid was incurred and the interest is borne by that permanent establishment. The general rule also does not apply if the person paying the interest is a resident of a Contracting State and has a permanent establishment in a State other than a Contracting State in connection with which the indebtedness on which the interest is paid was incurred and the interest is borne by that permanent establishment. In those cases in which the aforementioned exceptions to the general rule apply, such interest will be deemed to be from sources within the State in which the permanent establishment is located. The general rule set forth above in the first sentence corresponds generally to the Internal Revenue Code provision dealing with interest (other than interest on deposits with persons carrying on the banking business). The exceptions to this general rule, set forth above, are not contained in the Internal Revenue Code but are substantially similar to the rules contained in the United States-Belgian Income Tax Convention signed July 9, 1970. In the case of interest incurred in connection with the purchase of ships or aircraft, the residence of the payor will normally be determinative of the source of interest.

In determining whether a permanent establishment exists in a third State, the principles for determining the existence of a permanent establishment in one of the Contracting States (Article 9) are to be applied.

Royalties, described in paragraph (3)(a) and (b) of Article 14, other than payments for the use of, or the right to use, ships or aircraft, will be treated as income from sources within a State only if the property giving rise to the royalty is used within that State.

Income from real property including royalties from the operation of mines, quarries, or other natural resources and gains derived from the sale, exchange, or other disposition of such property or the right giving rise to such royalties, will be treated as income from sources within a State only if such property is located in that State.

Income from the rental of tangible personal property (other than income from the rental of ships or aircraft) will be treated as income from sources within the State in which such property is located. Income from the rental of ships or aircraft derived by a person not engaged in the operation of ships or aircraft in international traffic is to be treated as income from sources within a Contracting State only if the lessee is a resident of that State.

Compensation (other than directors' fees described in paragraph (5) of Article 18) received by an individual for his performance of labor or personal services, as an employee or in an independent capacity will be treated as income from sources within a State only if such services are performed in that State. However, compensation for labor or personal services performed aboard ships or aircraft operated by a resident of a Contracting State in international traffic will be treated as income from sources within that State, provided that the labor or services are performed by a member of a regular complement of the ship or aircraft. For purposes of this paragraph, compensation for labor or personal services includes pensions as defined in paragraph (2) of Article 23 paid in respect of such services. Notwithstanding the preceding, remuneration described in Article 21 (relating to governmental functions) is to be treated as income from sources within a State only if paid by, or out of the funds to which contributions are made by, that State or a political subdivision or local authority thereof. Directors' fees described in paragraph (5) of Article 18 are to be treated as income from sources within a State only if the corporation of which the individual is a director is a corporation of that State.

Income from the purchase and sale of personal property, whether tangible or intangible (other than gains defined as royalties in paragraph (3)(b) of Article 14 (relating to royalties)), is to be treated as income from sources within a State only if such property is sold in that State. This rule conforms fully to the rule set forth in section 861 (a)(6) of the Internal Revenue Code.

Notwithstanding the above - described rules, paragraph (8) of Article 6 provides that industrial and commercial profits attributable to a permanent establishment which the recipient, being a resident of one State has in the other State, including income dealt with in the articles pertaining to income derived from real property and natural resources and dividends, interest, royalties and capital gains, if from rights or property which are effectively connected with such permanent establishment, will be treated as income from sources within that other State. This source rule is consistent with one of the underlying policies of the Foreign Investors Tax Act of 1966 [1966-2 C.B. 656] in that the force of attraction principle is abandoned in favor of the adoption of the effectively-connected concept, although it should be noted that while the 1966 Act abandons the principle in part, the Convention abandons it fully. This change in policy is also reflected in the U.S. conventions entered into or substantially modified since that time. Under sections 871 (b) and 882 (a) of the Internal Revenue Code, as amended by the Foreign Investors Tax Act of 1966, United States tax is imposed at the usual rates on taxable income which is effectively connected with the conduct of a trade or business within the United States by a nonresident alien or a foreign corporation. Under section 864 (c), as amended by the Act, capital gains and losses and certain other income (including interest, dividends, rents, royalties and capital gains) of a nonresident alien or foreign corporation from sources within the United States may be effectively connected with the conduct of a trade or business within the United States, depending upon the application of various factors; all other income from United States sources is treated as effectively connected with the conduct of a trade or business within the United States. Only limited types of income from sources outside the United States are treated as effectively connected with the conduct of a trade or business within the United States. Thus, under the Code, the determination of the source of income is separate from and preliminary to, the determination of whether income if effectively connected with the conduct of a trade or business within the United States.

The source of income is determined differently under paragraph (8) of Article 6 of the Convention. In effect, source of income depends on whether income is attributable to a permanent establishment (or whether the property or right giving rise to the interest, etc. is effectively connected with the permanent establishment) and is not dependent upon the determination of source under other rules. Thus, interest, dividends and other income dealt with in the other articles of the Convention are deemed to be from sources within the Contracting States in which the permanent establishment is situated if the property or rights from which they arise are effectively connected with that permanent establishment, regardless of the source of such income under the specific source rules.

The factors taken into account in determining whether property or rights are effectively connected with a permanent establishment will include whether the property or rights are used, or held for use, in carrying on industrial or commercial activity through such permanent establishment, and whether the activities carried on through such permanent establishment were a material factor in the realization of the income derived from such property or rights. For this purpose, due regard will be given to whether or not such property, rights or income were accounted for through such permanent establishment. These factors are substantially the same as the corresponding factors enumerated under section 864(c)(2) of the Code.

Most of the source rules set out in this article differ in minor respects from those existing in the Internal Revenue Code. Since Article 4 (relating to general rules of taxation) provides that the Convention will not increase a person’s United States tax a taxpayer is entitled to use the more beneficial of the Code, or the Convention rules in calculating his income for United States tax purposes, or in the case of a citizen or resident of the United States, his foreign tax credit. For example, the rule on interest in this article permits Japan, under the proper circumstances, to impose a tax on any interest paid by a permanent establishment in Japan of a United States resident. While the rule appears to be fully reciprocal, the United States will not, because of section 861 (a)(1)(C) and (D) of the Code impose on nonresident aliens and foreign corporations a tax on interest paid by a resident of Japan unless 50 percent or more of such resident's gross income (for the 3-year period ending with the close of the taxable year of such resident preceding the payment of such interest) is effectively connected with the conduct by the resident of a trade or business in the United States. However, in the case of a United States branch of a Japanese bank, interest paid by such branch to a nonresident alien or foreign corporation is treated as sourced outside the United States provided it is not effectively connected with the conduct of trade or business in the United States by the recipient. If the interest is so effectively connected, or if paid to a U.S. corporation, citizen or resident, the interest is treated as U.S. source income. After 1975, all interest paid by a U.S. branch of a foreign bank will be treated as U.S. source income.

While, as stated, a U.S. taxpayer can choose between the source rules of the Convention or the Code, the taxpayer cannot combine the source rules of the Convention and the Code with respect to an item of income to achieve a benefit greater than that he could have achieved under either the Code or the Convention.

It should also be noted that the source rules do not serve to extend the benefits of the Convention to persons other than residents of the two States. Because the rules are only applicable for taxing residents of either State, they are not applicable in determining source of income of residents of other States, although the income of such other residents is of a type referred to in this article.

ARTICLE 7
Nondiscrimination

The Convention bans discrimination by one State against the citizens of the other State or permanent establishments of residents of the other State (as compared with its own citizens or residents) or corporations owned by residents of the other State (as compared with corporations owned by its own residents). Thus, for example, a citizen of Japan who is a resident of the United States and who meets the requirements specified in section 911 of the Internal Revenue Code would, under this article of the Convention, be eligible for the benefits of section 911 although he is not a citizen of the United States.

This article provides, however, that a State need not accord to residents of the other State special treatment accorded to its own residents on the basis of civil status or family responsibility.

Under paragraph (3) of Article 1, the ban on discrimination extends to all taxes without regard to subject matter and whether imposed at the national, state, or local level.

ARTICLE 8
Business Profits

This article sets forth the usual treaty rule that industrial or commercial profits of a resident of one State are taxable in the other State only if the resident has a permanent establishment in that other State. Where there is a permanent establishment, only the profits attributable to the permanent establishment can be taxed by that other State. For purposes of Article 5 (relating to relief from double taxation) which provides for the granting of a foreign tax credit by a State with respect to the other State's taxes on income from sources within that other

State, such profits are considered to be from sources within the State in which the permanent establishment is located.

While under the 1954 Convention, as under most of the old United States conventions, industrial or commercial profits were not taxed in the absence of a permanent establishment, once there was a permanent establishment the 1954 Convention (as did all such old conventions) provided generally that the provisions reducing the tax rate on interest, dividends, and royalties were not applicable. This rule, known as the "force of attraction" principle, is replaced in the new Convention, as in all our recent conventions, with the "effectively connected" concept. Under the new approach, only interest, dividends, and royalties which are effectively connected with the permanent establishment are taxable as part of the industrial or commercial profits and do not benefit from the reduced rate.

In determining the proper attribution of industrial or commercial profits under the new Convention, paragraph (2) of this article provides generally that a permanent establishment will be treated as if it were an independent entity and considered as realizing the profits which would be realized if the permanent establishment dealt with the resident of which it is a permanent establishment on an arm's length basis. Under paragraph (3), expenses, wherever incurred, which are reasonably connected with profits attributable to the permanent establishment, including executive and general administrative expenses, will be allowed as deductions by the State in which the permanent establishment is located in computing the tax due to such State. However, it is not necessary to allow a profit to the head office for ancillary services furnished to the permanent establishment even though the permanent establishment deducts the allocable costs incurred by the head office.

Paragraph (4) of this article provides that the mere purchase of goods or merchandise in a State by a permanent establishment of a resident of the other State, or by the resident, for the account of such resident will not cause attribution of profits to such permanent establishment. It is not intended that paragraph (2) of this article should override paragraph (4). Thus, where a permanent establishment maintained in one of the States by a resident of the other State purchases goods for the account of that resident, and the purchasing activity is not an integral part of a broader range of activities carried on by the permanent establishment, no attribution of industrial and commercial profits will be made under paragraph (2) with respect to that activity of the permanent establishment.

The term "industrial or commercial profits" is defined by setting forth several examples of activities which constitute the active conduct of a trade or business, including, *inter alia*, insurance activities, agricultural activities the furnishing of personal services, and the rental of tangible personal property other than ships or aircraft. The term also includes income derived from real property and natural resources, dividends, interest, royalties, and capital gains arising from property which is effectively connected with a permanent establishment. The term does not include income received by an individual as compensation for personal services (either as an employee or in an independent capacity) and income derived by a corporation or other entity of a State from sources within the other State from furnishing personal services of an individual who does not or would not qualify for exemption under paragraph (2) of Article 18 (relating to dependent personal services) by reason of paragraph (3) thereof.

Income from the rental of ships or aircraft is discussed under Article 10 (relating to shipping and air transport) and Article 14 (relating to royalties).

ARTICLE 9

Permanent Establishment

This article defines the term "permanent establishment". The existence of a permanent establishment is, under the terms of the Convention, a prerequisite for one State to tax the industrial or commercial profits of a resident of the other State. The concept is also significant in determining the applicability of other provisions of the Convention, such as Articles 12 (relating to dividends), 13 (relating to interest), 14 (relating to royalties), and 16 (relating to capital gains). The definition of "permanent establishment” is a modernized version of the definition found in some of our older treaties, including the 1954 Convention. The new definition is similar to the definition found in most of our recent conventions.

The term "permanent establishment" means "a fixed place of business through which a resident of a Contracting State engages in industrial or commercial activity". Illustrations of the concept of a fixed place of business include a branch, an office, a factory, a workshop, a warehouse, a place of extraction of natural resources, or a building site or construction or installation project which exists for more than 24 months. The construction project rule is a physical presence test under which the resident must be actively engaged in the project during the specified period. The time period has been expanded from the 12-month period used in the 1954 Convention in recognition of the changing nature of construction activity whereby a construction project may continue for more than 12 months and still maintain its essentially temporary nature. The 1954 Convention provided that an enterprise of one Contracting State had a permanent establishment in the other Contracting State if it carried on supervisory activities in the other State for more than 12 months in connection with a construction, installation, or assembly project located in the other State. The conduct of such supervisory activities has not been included in the illustrations of the concept of a fixed place of business in the new Convention. The determination of whether the conduct of supervisory activities constitutes a permanent establishment will be made upon the basis of the principles ordinarily used in making such a determination. As a general rule, any fixed facility through which an individual, corporation, or other person conducts industrial or commercial activity will be treated as a permanent establishment unless it falls in one of the specific exceptions described below.

This article specifically provides that a permanent establishment does not include a fixed place of business of a resident of one of the Contracting States which is located in the other Contracting State if it is used only for one or more of the following:

(1) the storage, display, or delivery of goods or merchandise belonging to the resident;

(2) the maintenance of a stock of goods or merchandise belonging to the resident for the purpose of storage, display, or delivery;

(3) the maintenance of a stock of goods or merchandise belonging to the resident for the purpose of processing by another person;

(4) the purchase of goods or merchandise, or the collection of information, for the

resident; or

(5) advertising, the supply of information, the conduct of scientific research, or similar activities which have a preparatory or auxiliary character, for the resident.

These exceptions are cumulative and a site or facility used solely for one or more of these purposes will not be considered a permanent establishment. The exception for cases where goods of a resident are processed by another person includes cases where the resident furnishes the other person with the tools and dies necessary for the processing. Although no specific exception is made in the case of a building site or construction or installation project which exists for not more than 24 months, the Convention implies that such a site or project does not constitute a permanent establishment.

Notwithstanding the other provisions of this article, a person will be considered to have a permanent establishment if he engages in business through an agent, other than an independent agent, who has and regularly exercises authority to conclude contracts in the name of such person unless the agent only exercises such authority to purchase goods or merchandise.

The Convention also provides that a resident of one State will not be deemed to have a permanent establishment in the other State if such resident engages in industrial or commercial activity in such other State through an independent agent, such as a broker or general commission agent, if such agent is acting in the ordinary course of its business.

The determination of whether a resident of one State has a permanent establishment in the other State is to be made without regard to any control relationship between such resident and a resident of the other State or a person which engages in industrial or commercial activity in that other State (whether through a permanent establishment or otherwise).

Where it is necessary under the Convention to determine whether a permanent establishment exists in a third State, the standards of this article are to be applied. Such a determination may be necessary under paragraph (2) of Article 6 relating to the source of interest income.

ARTICLE 10
Shipping and Air Transport

This article provides that, notwithstanding Article 8 (relating to business profits) and Article 16 (relating to capital gains), income which a resident of the United States derives from operation in international traffic of ships or aircraft registered in the United States, and gains which a resident of the United States derives from the sale; exchange, or other disposition of ships or aircraft operated in international traffic by such resident and registered in the United States, are exempt from tax in Japan.

This article provides a similar exemption from United States tax for such income and gains derived by a resident of Japan. However, with regard to income of residents of Japan, the ships or aircraft need not be registered in Japan if they are leased by such a resident.

This article does not contain any provision exempting shipping or air profits from local taxes. However, it was agreed in an exchange of notes accompanying the Convention that the enterprise tax levied in Japan on behalf of local governments would not be imposed on United States airlines and shipping companies if state, county, or local governments in the United States do not levy upon Japanese airlines and shipping companies any tax of a character substantially similar to the enterprise tax in Japan. The enterprise tax is a tax imposed by Japan for the prefectures upon net profits from business. It is imposed upon both individuals and corporations, although the rates and method of calculating net profits are somewhat different. At the present time, no such state or local tax is imposed on Japanese airlines and shipping companies in the United States.

In addition, notes were exchanged covering the use of containers in international traffic and the lease of ships or aircraft used in international traffic. It was agreed that income derived by a resident engaged in the operation in international traffic of ships or aircraft from the use, maintenance, or lease of containers and related equipment in connection with such operations is exempt as falling within the scope of this article. It was also agreed that income derived by a resident engaged in the operation in international traffic of ships or aircraft from a full or bareboat charter to another person engaged in the operation in international traffic of ships or aircraft also falls within the scope of this article.

Consistent with the above principles, other income from the leasing of ships or aircraft received by a person engaged in the operation in international traffic of ships or aircraft (*i.e.*, a lease to a person not engaged in international traffic) may also be within the scope of this article if such leasing activity is subsidiary and ancillary to the lessor's international operations.

ARTICLE 11
Related Persons

This article complements section 482 of the Internal Revenue Code and confirms the power of each government under its internal laws to allocate items of income, deduction, credit, or allowance in cases in which a resident of one State is related to any other person if such related persons impose conditions between themselves which are different from conditions which would be imposed between independent persons. A similar provision was included in the 1954 Convention and in the OECD Model Convention.

Provision is made in Article 25 (relating to mutual agreement procedures) for consultation and agreement between the two States where an allocation by either State results or would result in double taxation.

ARTICLE 12
Dividends

The 1954 Convention provided that dividends derived from sources within one State by a resident of the other State not having a permanent establishment in the former State (other than certain permanent establishments of the construction type) would be subject to tax in the former State at a rate not in excess of 15 percent. However, it provided for a 10 percent rate with respect to intercorporate dividends if, for the 12 months immediately preceding the date of payment, the recipient owned more than 50 percent of the stock of the paying corporation either alone or in association with not more than three other corporations of such other State, provided that each such corporation of the other State - owned 10 percent or more of the stock of the payor corporation and, generally, if not more than 25 percent of the gross income of the paying corporation for such period consisted of dividends and interest.

The new Convention continues the 15 percent rate with respect to dividends on portfolio investments and the 10 percent rate on intercorporate dividends. However, under the new Convention the maximum rate of 10 percent with respect to intercorporate dividends applies if, during the part of the paying corporation's taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year, the recipient owns 10 percent or more of the voting shares of the paying corporation and, generally, if not more than 25 percent of the gross income of the paying corporation for such prior taxable year consists of dividends and interest.

The dividend article is patterned generally after the OECD Model Convention except, with respect to the qualification for the 10 percent intercorporate dividend rate, a 10 percent ownership requirement is substituted or the 25 percent ownership requirement of the OECD draft. The 10 percent rule conforms to the United States concept of direct investment especially as expressed in section 902 of the Internal Revenue Code. In addition, the Convention limits to 25 percent the amount of passive income which may be derived by a corporation paying dividends in order to qualify for the reduced intercorporate dividend rate. This provision, which is included in most conventions to which the United States is a party but which is not found in the OECD draft, reflects the policy that the reduced rate should not be made available to dividends paid by certain holding companies. Dividends and interest received by the payor corporation from 50 percent or more owned subsidiaries are not considered passive income.

The use of the term "actually distributed" is intended to make clear that the rate of withholding applies to the amount paid by the distributing corporation and not to the amount received (which would be a lesser amount due to withholding). The term is not intended to mean that there must be an actual physical transfer of funds for the reduced rates to apply, as in the case of the obligation to pay a dividend being satisfied by the offset of an account payable by the stockholder to the distributing corporation.

The Convention abandons the "force of attraction" concept in the 1954 Convention by providing that the reduced rates of tax on dividends are denied only if the share with respect to which the dividends are paid are effectively connected with a permanent establishment which the recipient has in the State of source. The elimination of the "force of attraction" principle will make uniform the rate of tax levied on dividend income received by a resident of one State from sources within the other State unless such income is effectively connected with a permanent establishment maintained in the State of source by the resident. In those cases where the shares with respect to which the dividends are paid are so effectively connected, the dividends may be taxed as industrial or commercial profits under Article 8 (relating to business profits) at normal rates applicable to such income in the State of source.

The Convention does not contain the provision found in many of our recent conventions limiting the right of a State to tax dividends paid by a corporation of the other State to residents of third States. This could not occur under present Japanese tax law since a dividend paid by a United States corporation would be considered United States sourced and would, therefore, not be subject to Japanese tax when received by a nonresident of Japan. However, under sections 861(a)(2)(B) and 1442 of the Internal Revenue Code, dividends paid by a Japanese corporation to a resident of a third State could be treated in whole or in part as United States source income if such a case were to arise. This could happen only where over 50 percent of the Japanese corporation's income is effectively connected with a U.S. trade or business over a specified 3-year period of time.

ARTICLE 13
Interest

The 1954 Convention provided that interest derived from sources within one State by a resident of the other State not having a permanent establishment in the former State would be subject to tax in the former State at a rate not in excess of 10 percent.

The new Convention retains the 10-percent rate on interest. The Convention also provides that interest derived from sources within the United States will be exempt from United States tax if such interest is derived by the Bank of Japan or by the Export- Import Bank of Japan, or by any resident of Japan either with respect to debt obligations guaranteed or indirectly financed by either of such Japanese banks or with respect to debt obligations insured by Japan pursuant to Law No.67, March 31, 1950, concerning Export Insurance. In an exchange of notes the Contracting States stated an understanding that a debt obligation would be treated as indirectly financed by the Export-Import Bank of Japan in cases where that Bank provides funds in the form of export credit, import credit, or investment credit to a resident of Japan for the purpose of permitting the resident of Japan to extend credit to a resident of the United States and the debt obligation represents such extension of credit to the resident of the United States.

A reciprocal exemption is also provided in the case of interest derived from sources within Japan by any Federal Reserve Bank in the United States or by the Export-Import Bank of the United States, or by any resident of the United States with respect to debt obligations guaranteed, insured, or indirectly financed by any of such United States banks.

The 1954 Convention provided similar reciprocal exemptions, but the exemptions were limited to interest derived by the central banks and the Export-Import Banks of the Contracting States.

As noted above in connection with Article 12 (relating to dividends), the Convention abandons the "force of attraction" principle, replacing it with the effectively connected approach. Thus, the reduced rates of tax and the exemptions applicable to interest apply unless the recipient has a permanent establishment in the State of source and the indebtedness giving rise to the interest is effectively connected with such permanent establishment. In such a case, the interest may be taxed as industrial or commercial profits.

Interest is defined generally as income from any kind of debt-claim or any income treated as interest under the tax law of the State of source. If excessive interest is paid by a payor who is related to the recipient, the provisions of this article apply only to so much of the interest as would have been paid to an unrelated person. Excess interest payments may be taxed by each State according to its own law including the provisions of the Convention where applicable.

The source of interest income is determined under paragraph (2) of Article 6 (relating to the source of income)

As in the case of dividends, the Convention does not contain the provision found in many of our recent conventions exempting from tax by one of the States interest paid by a resident of the other State to a resident of a third State. Under Japanese tax law, interest paid by a United States resident to a resident of a third State would not be subject to Japanese tax, but under sections 861(a)(1)(C) and (D) and 1442 of the Internal Revenue Code, interest paid by a Japanese corporation to a resident of a third State could be subject to United States tax in exceptional circumstances. This could happen only where 50 percent or more of the Japanese corporation's gross income is effectively connected with the conduct of a U.S. trade or business over a specified 3-year period.

ARTICLE 14
Royalties

The 1954 Convention provided that royalties derived from sources within one State by a resident of the other State not having a permanent establishment in the former State (or having a permanent establishment of the construction type if the royalties are not attributable thereto) would not be subject to tax in the former State at a rate in excess of 10 percent.

The new Convention retains the 10-percent rate on royalties. However, as noted above in connection with Article 12 (relating to dividends) and Article 13 (relating to interest), the Convention abandons the "force of attraction" principle, replacing it with the effectively connected approach. Thus, the reduced rate of tax applies unless the recipient has a permanent establishment in the State of source and the property or rights giving rise to royalties are effectively connected with such permanent establishment. In such a case, the royalties may be taxed as industrial or commercial profits.

The term "royalties" is defined to include

(a) payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, scientific works, or motion picture films or films or tapes used for radio or television broadcasting, patents; designs, or models, plans, secret processes or formulae, trademarks, or other like property or rights, or know-how, or ships or aircraft (but only if the lessor is a person not engaged in the operation in international traffic of ships or aircraft) and

(b) gains derived from the sale, exchange, or other disposition of such property or rights (other than ships or aircraft) to the extent that payment is contingent on productivity, use or disposition of the property or rights.

If the payments in the second category are not so contingent, Article 16 (relating to capital gains) applies. The term "know-how" includes existing scientific, technical, industrial and commercial knowledge or information where such knowledge or information is transmitted or supplied to the payor (as opposed to a contract for the development of knowledge or information or for the use of knowledge or information by the payee in connection with the rendition of services to the payor). The term also includes assistance of an ancillary and subsidiary nature furnished as a means of enabling the application or enjoyment of a transferred intangible.

If excessive royalties are paid between a payor and a related recipient, the provisions of this article apply only to so much of the royalty as would have been paid to an unrelated person. The excess payment may be taxed by each State according to its own law including the provisions of the Convention where applicable.

The source of income from royalties is determined under paragraph (3) of Article 6 (relating to the source of income).

ARTICLE 15
Income from Real Property

This article provides that a resident of one State may be subject to tax in the other State on income from real property and royalties in respect of natural resources if the property or natural resource is located in such other State. The 1954 Convention provided that a resident of one State may be subject to tax on such income or royalties by the other State only if such resident had a permanent establishment in the other State or if such income or royalties constituted industrial or commercial profits. This article does not (as did the 1954 Convention) provide for an election by the resident to compute his tax on such income on a net basis since under the internal laws of Japan and, since 1967, the United States, this can be done. See sections 871(d) and 882(d) of the Internal Revenue Code. The income referred to in this article includes gain from the sale or exchange of real property or natural resource rights, but does not include interest on mortgages and similar instruments. The latter type of income is covered by Article 13 (relating to interest).

ARTICLE 16
Capital Gains

The 1954 Convention provided no special rules for gains derived in one State from the sale or exchange of stock, securities, commodities, or other capital assets by a resident of the other State. The new Convention provides that such gains shall be taxable only by the resident's State. However, the other State may also tax such gain if

(1) the gain derived by the resident arises out of the sale or exchange of property described in Article 15 (relating to income from real property) which is situated within the other State,

(2) the gain arises out of a sale or exchange described in paragraph (3)(b) of Article 14 (relating to royalties) and is taxable in the other State under that Article,

(3) the recipient of the gain has a permanent establishment in the other State and the property giving rise to the gain is effectively connected with such permanent establishment, or

(4) the recipient of the gain, being an individual, either is present in the other State for a period or periods aggregating more than 183 days in the taxable year or maintains, for a period or periods aggregating more than 183 days during the taxable year, a fixed base in the other State with which the property giving rise to such gains is effectively connected.

Gains arising from property which is effectively connected with a permanent establishment may be taxed as industrial or commercial profits under Article 8 (relating to business profits). Gains on real property are subject to the provisions of Article 15 (relating to income from real property) which permits taxation of such gains by the State in which the real property is situated. The fixed base concept is discussed in greater detail in relation to Article 17 (relating to independent personal services).

Under Japanese tax law, without regard to the Convention, gains from the sale of patents and similar intangible property or rights are considered royalties. By reason of this article (and Article 14), however, such gains, except those described in paragraph (3)(b) of Article 14 (relating to sales of intangibles where the purchase price is contingent upon productivity or use) are treated as capital gains and not as royalties for all purposes of the Convention.

Although under Japanese law, in certain circumstances, a foreign stockholder of a Japanese corporation is subject to Japanese tax on the disposition of the stock of the Japanese corporation regardless of the reorganization nature or place of the disposition, this article may nevertheless apply to exempt U.S. stockholders from such tax.

ARTICLE 17
Independent Personal Services

The 1954 Convention combined the rules pertaining to independent and dependent personal services into one article.

The new Convention generally deals with personal services in two articles and creates a distinction based upon whether the services are independent or dependent personal services. The Convention also provides a special rule for independent individuals who are public entertainers and a special rule dealing with directors' fees. A doctor or lawyer, for example, typically renders independent personal services. Also an entertainer who under common law concepts is an independent contractor is considered as rendering independent personal services.

Generally, under Article 17, income earned by an individual resident of one State from independent personal services performed in the other State may not be taxed in that other State.

However, such income may be subject to tax in the State of source (*i.e.*, where the services are performed) if the recipient is present in that State for a period or periods aggregating more than 183 days in the taxable year or if the individual maintains a fixed base in that other State for a period or periods aggregating more than 183 days in the taxable year, but in the latter case only on the income attributable to such fixed base.

Commercial, industrial, or agricultural activities would not normally be considered independent personal services and the income therefrom would, therefore, be industrial or commercial profits subject to the rules of Article 8 (relating to business profits).

Under the fixed base concept if a physician, resident in one State, has an office regularly available in the other State for a period aggregating more than 183 days during the taxable year, the income he earns from the performance of services within the other State will be subject to tax in that other State regardless of whether he is physically present in that other State for more than 183 days during the taxable year and regardless of whether others make use of this office.

An individual who derives income from independent personal services as a public entertainer is nevertheless subject to tax in the other State if his stay in such State exceeds 90 days during the taxable year or his income (excluding reimbursed travel expenses) is in excess of $3,000, or its equivalent in Japanese yen, in the aggregate during the taxable year.

ARTICLE 18
Dependent Personal Services

Generally, under the Convention income from labor or personal services derived as an employee (including remuneration derived by an officer or a member of the board of directors of a corporation) may be taxed by the State of source (which, except in the case of directors' fees described in paragraph (5) of this article, is the State in which such labor or personal services are performed). However, such income will be exempt from tax in the State of source if

(1) the recipient, being a resident of the other State, is present in the State of source for a period or periods not exceeding in the aggregate 183 days during the taxable year;

(2) the recipient is an employee of either a resident of the State of his residence or of a permanent establishment of a resident of a State other than the State of his residence (if the permanent establishment is situated in the State of his residence) ; and

(3) the remuneration is not borne as such by a permanent establishment which the employer has in the State of source.

The use of the term "as such" generally restricts the scope of the third standard to situations in which the remuneration is paid by the permanent establishment to the employee. In contrast, if the head office regularly charges the permanent establishment for "home office" expenses attributable to the permanent establishment, which expenses include the remuneration paid by the home office to the employee, the remuneration is not borne "as such" by the permanent establishment.

Under the 1954 Convention, income from labor or personal services performed in one

State by an employee who was a resident of the other State was exempt from the tax of the first State in any taxable year in which the employee was temporarily present in the first State for a period or periods not exceeding a total of 180 day's during such taxable year and such income was received for labor or personal services performed as an officer or employee of a resident, corporation, or other entity of the employee's State of residence.

The exemption provided by this Article of the new Convention does not apply to an employee if

(1) such employee is a substantial owner (as defined below) of the corporation or other entity which is the employer, and

(2) at least 50 percent of the income of the employer for the taxable year from sources within the State of source is derived from furnishing labor or personal services of one or more individuals each of whom is a substantial owner of the employer.

Such income of the employer is computed without deductions for compensation paid to such individual substantial owners. An individual will be treated as a substantial owner of the employer if

(1) he owns directly or indirectly at least 25 percent of the total voting power of all classes of stock entitled to vote, or of the total value of all classes of stock of such corporation or other entity, or

(2) he has directly or indirectly an interest of 25 percent or more in the assets, or has a right to 25 percent or more of the profits of such other entity. An individual is deemed to own the stock, assets, or rights owned directly or indirectly by his brother, sister, spouse, ancestor, or descendant.

The Convention also provides that income from personal services aboard ships or aircraft operated by a resident of one State in international traffic will not be taxed in the other State so long as the services are rendered by a member of the regular complement of the ship or aircraft.

The 1954 Convention contained no specific provision concerning fees received by an individual resident of one State for services performed in the other State as a director of a corporation of such other State. However, such fees were exempt from the tax of such other State if the individual qualified under the general provision for exemption of compensation for personal services. If the individual was not an employee of the corporation, the exemption applied if he was temporarily present in such other State for a period or periods not exceeding a total of 90 days during the taxable year and his compensation for labor or personal services performed in such other State did not exceed $3,000 (or its equivalent in Japanese yen). Under Japanese tax law, a portion of the remuneration paid to directors of a company may be treated as a sharing in the profits of the company and, accordingly, taxed as a distribution of profits rather than as compensation for services and no deduction is allowed to the corporation. Under the new Convention, a director's fee derived by an individual resident of a State in his capacity as a member of the board of directors of a corporation of the other State which is treated as described above may be taxed by that other State. Paragraph (6) of Article 6 (relating to source of income) provides that such payments are sourced in that other State. Accordingly, in the case of a director's fee paid to a United States resident by a Japanese corporation and taxed by Japan, the foreign tax credit is available to such resident with respect to the fee.

ARTICLE 19
Teachers and Researchers

This article substantially follows the rules contained in the 1954 Convention. The new Convention provides an exemption from tax which applies to an individual who, at the invitation of either the Government of a State or an accredited educational institution of that State, is temporarily present in such State for the primary purpose of teaching or engaging in research, or both, at such an accredited educational institution. In order for the exemption to apply, the individual must either be a resident of the other State at the time he comes to visit the host State or, until the time the exemption commences under this article, he must have been exempt from tax in the host State under paragraph (1)(a) of Article 20 (relating to students and trainees). Since the period of temporary visit may be of such duration that an individual may lose his status as a resident of the State of which he was a resident, the article makes clear that the individual need only be a resident of such state (or exempt under Article 20) at the beginning of his visit. The exemption is for the individual's income from personal services for teaching or research at such accredited educational institution. The exemption extends for a period which in no case may exceed two years from the individual's arrival for the purpose of teaching or research or from the date he completed the study, training, or research with respect to which the exemption in paragraph (1)(a) of Article 20 applied, whichever is applicable. In addition, under Article 22 (relating to rules applicable to personal income articles), the combination of consecutive exemptions under Article 20 and this article may not extend beyond 5 taxable years from the date of the individual's arrival. If the individual's visit exceeds the period of time for which the exemption under this article is applicable, the exemption applies to the income received by the individual before the expiration of such period. The exemption does not apply to income from research undertaken not in the public interest but primarily for private benefit of a specific person or persons.

ARTICLE 20
Students and Trainers

The 1954 Convention provided that a resident of one State who was temporarily present in the other State solely as a student at a recognized university, college or school was exempt from the tax of the other State with respect to remittances from abroad, including any payments by his employer abroad. There was a similar exemption with respect to a grant, allowance, or award (other than compensation for personal services) from a religious, charitable, scientific, literary, or educational organization of the State of residence of an individual who was temporarily present in the other State and to whom the grant, allowance, or award was remitted from abroad.

The new Convention provides an exemption for an individual who is a resident of one State, who, at the time he is a resident of that State, becomes temporarily present in the other State for the purpose of studying at a university or other accredited educational institution, securing training for qualification in a profession, or studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary; or educational institution. Such an individual is exempt from tax in the host State on:

1. Gifts from abroad for his maintenance and study;
2. The grant, allowance, or award; and
3. Income from personal services performed in the host State in the aggregate amount not in excess of $2,000 (or its equivalent in Japanese yen) for any taxable year.

Under this article and paragraph (3) of Article 22 (relating to rules applicable to personal income articles), these exemptions continue only for such period of time as may be reasonably or customarily required to effectuate the purpose of his visit but in no event may an individual have the benefit of this provision for more than a total of 5 taxable years from the date of his arrival.

In addition, a resident of one State employed by, or under contract with, a resident of that State who, at the time he is a resident of that State, becomes temporarily present in the other State for the purpose of studying or acquiring technical, professional, or business experience from a person other than a resident of the first-mentioned State, is exempt from tax in the host State on income not in excess of $5,000 (or its equivalent in Japanese yen) from personal services. The individual is exempt for a period of 12 consecutive months which period commences with the first month in which he begins working or receives compensation. The 1954 Convention provided a corresponding exemption of $6,000 (or its equivalent in Japanese yen). However, the application of the exemption was in other respects more restricted than in the new Convention since it applied only in cases in which the individual was temporarily present solely to acquire technical, professional, or business experience from a person other than his employer. The old exemption applied only to compensation from abroad paid by such individual's employer for his services rendered during the period of his temporary presence.

Also, an individual who is a resident of one State who, at the time he is a resident of that State, becomes temporarily present in the host State as a participant in a government program of the host State for the primary purpose of training, research, or study is entitled to an exemption by the host State with respect to his income from personal services relating to such training, research, or study performed in the host State in an amount not in excess of $10,000 (or its equivalent in Japanese yen). To be entitled to this exemption, the individual's presence in the host State must not exceed one year in duration.

If a person covered by this article derives income in excess of the amount specified ($2,000; $5,000; or $10,000), the exemption applies up to the applicable maximum and the excess is subject to tax in the normal manner.

ARTICLE 21
Governmental Functions

The provisions of the 1954 Convention with respect to governmental functions were substantially the same as those of the new Convention. The new Convention provides an exemption from Japanese tax with respect to wages, salaries, and similar remuneration, including pensions or similar benefits, paid by (or from the public funds of) the United States, or a political subdivision or local authority thereof, to a citizen of the United States for services performed for the United States or for any of its political subdivisions or local authorities in the discharge of governmental functions, provided such individual is not a national of Japan and has not been admitted to Japan for permanent residence. An exemption from United States tax is provided with respect to such payments paid by (or out of funds to which contributions are made by) Japan, or a local authority thereof, to an individual who is a national of Japan for services performed for Japan or for any of its local authorities in the discharge of governmental functions, provided such individual is not a citizen of the United States and does not have immigrant status in the United States. In the case of Japan, this article is applicable to payments made by the National Civil Servant Mutual Aid Association and the Local Civil Servant Mutual Aid Association. Compensation paid in connection with industrial or commercial activity carried on by a government is treated the same as compensation paid by a private employer. The provisions relating to dependent personal services, and pensions, annuities and social security payments would apply in such a case.

ARTICLE 22
Rules Applicable to Personal Income Articles

This article extends the benefits of the personal services income articles (Article 17 through 21) to reimbursed travel expenses. However, such reimbursed expenses will not be taken into account in computing the maximum amount of exemptions. Maximum amounts are specified in paragraph (2) of Article 17 (relating to income from independent personal services of a public entertainer) and in Article 20 (relating to students and trainees). If an individual qualifies for the benefits of more than one of the provisions of Article 17 through 21, he may choose the provision most favorable to him, but he may not claim the benefits of more than one article with respect to the same income in any one taxable year.

As noted above, if an individual qualifies for the benefits provided under Article 19 (relating to teachers and researchers) or paragraph (1) of Article 20 (relating to students and trainees), such benefits will extend only for that period of time which is reasonably and customarily required to effectuate the purpose of the visit. If an individual qualifies successively for the benefits provided under both of such provisions, such benefits will not extend, in any case, for more than a total of 5 taxable years from the date of his arrival.

ARTICLE 23
Pensions, Annuities, and Social Security Payments

The 1954 Convention did not provide any exemption from tax by the source State for pensions, annuities, and social security payments derived from sources within one State by individuals residing in the other State.

The new Convention provides that pensions and annuities received by a resident of a State will be taxable only in the State of residence. However, pensions coming within the scope of Article 21 (relating to governmental functions) are taxable according to that provision.

The term "pensions" is defined as including periodic payments, including United States and Japanese social security payments made by reason of retirement or death in consideration for services rendered, or by way of compensation for injuries received, in connection with employment. The term "annuities" is defined as including a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

The effect of this provision with respect to pensions is generally the same as that of the OECD Model Convention. The treatment of social security payments in the same manner as private pensions differs from their treatment in our recent Belgian, French, Finnish and Norwegian Conventions, under which social security payments are taxable only by the State of source.

ARTICLE 24
Diplomatic and Consular Officers

This article preserves the existing and subsequent fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements.

ARTICLE 25
Mutual Agreement Procedure

This article modernizes the mutual agreement procedures by adopting provisions similar to those in our recent treaties with Belgium, France, Finland and Norway and in the recent amendments to our Conventions with the Netherlands, the United Kingdom, and the Federal Republic of Germany. When a resident of one State considers that the action of one or both States has resulted, or will possibly result, in taxation contrary to the provisions of the Convention, such resident may present his case to the competent authority of the State of which he is a resident. This remedy is in addition to any remedy provided by the national laws of either State.

This article contemplates that the competent authorities of the two States will endeavor to settle by mutual agreement such cases of taxation not in accordance with the Convention as well as any other difficulties or doubts arising as to the interpretation or application of the Convention. Some particular areas on which the competent authorities may consult and reach agreement are:

the amount of industrial and commercial profits to be attributed to a permanent establishment,

the allocation of income, deductions, credits, or allowances between a resident and a related person,

the determination of source of particular items, and

the meaning of any term used in the Convention.

However, consultation and agreement between the competent authorities are not restricted to the particular areas described in this article. Thus, for example, the competent authorities may consult and reach agreement with respect to uniform accounting for income and deductions. While not all income tax conventions to which the United States is a party are as explicit as to the broad scope of the mutual agreement procedure, most of our conventions grant the discretion to competent authorities to apply the mutual agreement procedure to an equally broad category of items.

In implementing the provisions of this article, the competent authorities will communicate with each other directly and meet together for an exchange of oral opinions when advisable.

In cases in which the competent authorities reach agreement with respect to a particular matter, taxes will be adjusted and refunds or credits allowed in accordance with such agreement. This provision permits the issuance of a refund or credit notwithstanding procedural barriers otherwise existing under a State's law, such as the statute of limitations. This provision will apply only where agreement has been reached in whole or in part between the competent authorities and will apply in the case of any such agreement on or after the date on which the Convention entered into force (July 9, 1972) even though the agreement may concern taxable years prior thereto.

Revenue Procedure 70-18 [1970-2 C.B. 493] sets forth the procedure followed by the United States in implementing its obligations under this type of article.

ARTICLE 26
Exchange of Information

This article provides for a system of administrative cooperation between the competent authorities of the two States and specifies conditions under which information may be exchanged to facilitate the administration of the Convention and to prevent fraud and the avoidance of taxes to which the Convention relates. Pursuant to paragraph (3) of Article 1, this article applies to all national taxes of the two States.

Information exchanged is treated as secret and may not be disclosed to any persons other than those (including a court or administrative body) concerned with the assessment, collection, enforcement, or prosecution of taxes subject to the Convention. This does not prohibit disclosure in the course of a court proceeding. In no case does this article impose an obligation on either State to disclose trade secrets or similar information or to carry out administrative measures or supply particulars where such action would be at variance with the laws or administrative practice of that State, or contrary to public policy. In general, the standard for the exchange of information is the standard used by the States in the enforcement of their own laws by administrative and judicial authorities.

In addition, the new Convention specifically provides (as the 1954 Convention did not) that the competent authority of each State will advise the competent authority of the other State of any addition to or amendment of tax laws which concern the imposition of taxes which are the subject of the Convention. The competent authorities may also agree on a list of information to be exchanged on a routine basis. It is further provided that the competent authorities will exchange the texts of all published material interpreting the Convention under the laws of the respective States, whether in the form of regulations, rulings, or judicial decisions. The exchange of information may be either on a routine basis or on request with reference to particular cases.

ARTICLE 27
Assistance in Collection

This article provides for mutual assistance in the collection of taxes where required to avoid an abuse of the Convention. The provision is intended merely to insure that the benefits of the Convention will only be available with respect to persons entitled to such benefits; it does not in anyway alter the rights under other provisions of the Convention.

This article provides that each State will endeavor to collect for the other State such amounts as may be necessary to insure that any exemption or reduced rate of tax granted under the Convention will not be availed of by persons not entitled to those benefits. The 1954 Convention contained a similar provision. However, under a provision not explicitly contained in the 1954 Convention (but nonetheless implied), this article does not require a State, in order to collect taxes which are imposed by the other State, to undertake any administrative measures that differ from its internal regulations or practices nor does this article require a State to undertake any administrative or judicial measures which are contrary to that State's sovereignty, security, or public policy.

ARTICLE 28
Entry into Force

This article provides for the ratification of the Convention and for the exchange of instruments of ratification as soon as possible. The exchange of instruments of ratification took place on June 9, 1972. The Convention entered into force on the thirtieth day after the day of exchange of such instruments (July 9, 1972). However, the provisions of the Convention became effective, for both States, for income derived during any taxable year beginning on or after January 1, 1973, and, in the case of the United States, as respects taxes withheld at source on dividends, interest, royalties, and similar payments to any obligation to pay such taxes arising on or after January 1,1973.

In the case of Japan, no distinction is made with respect to the effective date for withholding taxes on dividends, interest, royalties, and similar payments, because foreign recipients of such payments are treated under Japanese internal law as having a taxable year beginning on January 1. This rule applies if a United States resident has a permanent establishment in Japan, even if the taxable year of such resident is different, except that the permanent establishment's taxable year would control if such payments are effectively connected with it. However, there would be no withholding if such payments are effectively connected with the permanent establishment.

The Convention of April 16, 1954 [1955-1 C.B. 658], as well as the Protocols of May 7, 1960 [1965-1 C.B. 611], and August 14, 1962 [1965-2 C.B. 562], terminated and ceased to have effect in respect of income to which the new Convention applies under the above-mentioned rules of this article.

ARTICLE 29
Termination

The Convention will continue in effect indefinitely, but may be terminated by either State at any time after 5 years from the date on which the Convention entered into force. A State seeking to terminate the Convention must give notice at least 6 months before the end of the calendar year through diplomatic channels.

If the Convention is terminated, such termination will be effective:

In the case of Japan:

For income derived during any taxable year beginning on or after January 1 next following the year in which the notice of termination is given.

In the case of the United States:

1. As respects taxes withheld at source on dividends, interest, royalties, and similar payments on January 1 next following the expiration of the 6-month period; and

2. As respects other taxes on income, for any taxable year beginning on or after January 1 next following the expiration of the 6-month period.

In the case of Japan, no distinction is made with respect to the termination date for purposes of withholding taxes on dividends, interest, royalties, and similar payments, because, as discussed with regard to Article 28 (relating to entry into force), foreign recipients of such payments are treated under Japanese internal law as having a taxable year beginning on January 1.