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CONTENTS

OPINION

The New Procedure for the Withholding Tax Certificate in Japan: A Paradoxical Solution?
FRANCESCO CAPUTO NASSETTI

ARTICLES

Secured Financing in the United States: Developments in 1994
A. BRUCE SCHIMBERG

International Credit Transfers: The Proposed EC Directive Compared with the UNCITRAL Model Law
LOTTE BØJER

Prospectus Liability in The Netherlands
HELEEN E.M. VELTHUYSE AND FRANCINE M. SCHLINGMANN

NEWS SECTION

An International Review of Cases and Recent Legislation

LEGAL ANALYSIS

The Private Finance Initiative and Local Authorities: Opportunities and Problems
GRAHAM REID

The US Securities and Exchange Commission and Extra-territorial Jurisdiction: Regulating the Markets
MARK L. BERMAN

Supreme Court Decisions on Austrian Banking Secrecy
MARKUS HEIDINGER AND SUSAN AMBLER SMITH

The Indian Budget 1995–96
VANDANA SHROFF

BOOK REVIEWS

The Payment System – Design, Management, and Supervision

European Community Law: A Practitioner's Guide (2nd edn)

Countertrade: Paying in Goods and Services

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OPINION

# The New Procedure for the Withholding Tax Certificate in Japan: A Paradoxical Solution?

FRANCESCO CAPUTO NASSETTI

The procedure relating to the withholding tax certificate has been analysed in an article entitled 'The Withholding Tax Certificate for Foreign Banks in Japan',[1] at the end of which the hope was expressed that the Japanese Government would eliminate the requirement, which is considered an unfair treatment for foreign banks in Japan. A brief summary of the procedure follows here below and the interested reader should refer to the above mentioned article for a detailed analysis.

Under the Japanese Income Tax Law an interest payer ('the payer' or the withholding tax agent, 'the agent') is required to withhold tax on interest payments if the recipient is a foreign corporation. There is, however, an exemption if the foreign corporation is in possession of permanent facilities in Japan. More precisely, if the foreign corporation in possession of permanent facilities in Japan (1) has obtained a certificate from the competent tax office stating that it has permanent facilities in Japan and (2) has delivered such certificate to the payer, the withholding tax is not applicable and interest can be paid gross. It was felt that this regulatory framework creates unequal treatment from three different perspectives, which are described in the aforementioned article.

On 31 March 1995 the Japanese Diet amended Article 180 of the Income Tax Law, introducing new legislation (section 42-2) with regard to the aforementioned certificate. Basically there will be only one certificate for each foreign bank ('FB') valid for one year, instead of one certificate to be delivered to each customer of each FB valid for five years.

The FB shall apply to the competent tax office for the issuance of the certificate, which will be valid for one year from the date of issue. For the extension or re-issuance of the certificate the application should be received by the competent tax office one month prior to the expiry of its validity date. If an FB loses the right to, or its qualification for, the withholding exemption, it must notify the competent tax office without delay. Failure to do so will be considered a criminal offence. In addition, the National Tax Administration (NTA) will notify the FB when it is to lose its qualification for exemption. In case of changes, such as a new name or address, the FB shall notify the tax office without delay.

Once issued, the FB shall *show* the certificate to the payer and the payer shall, *at the time of the payment of interest, confirm* that a valid certificate has been shown to him by the FB.

The first aspect of the new regulation to be considered is the interpretation of the term 'show'. In other words what does an FB have to do in order to 'show' the certificate to the payers? Will it be enough to display it on a wall of a room open to the public? Or what else?

Closely connected to this point is the interpretation of the term 'confirm'. What do the payers have to do in order to confirm that the certificate was shown to them? What kind of evidence must they have to prove that they were shown the certificate?

The original Japanese term used in the law, 'tei ji' ('show'), implies that the certificate is physically shown. Therefore, if the agent visits the FB premises and sees it on the wall, the law has been certainly respected. But how can the agent prove, maybe a few years later during an NTA inspection, that the certificate was shown to him? It

1. [1994] 11 JIBL at 486.

has been suggested that a photocopy of the certificate sent by the FB to the agent would be sufficient evidence and NTA seems inclined to prefer such evidence, since it is believed that having a photocopy implies having seen the original certificate. (In practice, even if the agent never saw the original certificate, but got a photocopy, NTA probably would not further investigate whether the action took place or not.) Therefore the crucial point is the evidence of the action, more than the action itself. However, if the sending of the photocopy is the solution preferred by the Ministry of Finance, the result of the deregulation would be – paradoxically – a major step backwards from an administrative point of view. In fact, the FB would be sending a photocopy of the certificate to each payer every year compared to the compulsory delivery to each payer of a certificate valid for five years: the administrative burden would be five times heavier than before!

The circular soon to be issued by the NTA regarding the implementation of the new law is not likely to contain any kind of interpretation on the above points (but will regulate the actual procedure for the issuance of the new certificate).

A practical way of overcoming the hurdle could be the following. Under Article 20 of the Japanese Banking Law all banks must compile a balance sheet and a profit and loss account of each business term and make them public within a three-month period after the end of each business term in a manner determined by an Ordinance of the Ministry of Finance. Article 19 of Ordinance no. 10 dated 31 March 1982 of the said Ministry states that 'the balance sheet and the income statement made public by a bank under the provisions of Article 20 of the (Banking) Law shall be compiled in forms similar to those given in ... appendix IV for foreign banks' branches'.

In compliance with the above regulation, FBs make public every year – approximately and mainly in June – the required information in a national daily financial newspaper (normally the vast majority of FBs use the Nikkan Kyogo Shimbun (Daily Industrial News). On this occasion FBs could also publicise the fact that they have obtained (or renewed) the certificate for the current fiscal year (and in theory the certificate can even be reproduced in the newspaper).

If the Japanese authorities accept the above procedure as valid evidence of *showing* the certificate for the FB and of *confirmation* for the payer, not only will the fivefold increase in administrative work be avoided, but also the problems linked to the probing of the actual implementation by the FB and payers of the respective actions will be overcome automatically, since the evidence will be publication in the newspaper itself (regardless of the actual existence of a copy of it in the files of the agent).

Leaving aside the interpretative aspects, which remain of paramount importance for the practical implementation and effectiveness of the deregulation, a broader consideration on the new law shall be made.

The previous procedure was based exclusively on a principle of rigid formality: the holding of the certificate was compulsory for the agent in order to pay gross interest, and without it the agent was obliged to pay net (a penalty was set for a gross payment without the certificate). Therefore, even if the FB was exempt (the certificate was duly issued to the FB), the lack of a certificate in the hands of the agent (due to non-delivery, loss and so on) *at the time of the payment of interest* would have not allowed the agent to pay gross interest and, in case of erroneous payment, the *ex post* receipt of the certificate could not correct the irregularity. The formality overrode the substance.

The new procedure gives more weight to the substance: the actual possession of the certificate or a copy of it is not required and, if the FB had obtained it and had received gross interest, the agent can prove, with the acquisition *ex post* of any necessary evidence, that at

the time of the payment of interests it was *confirmed* that a certificate was shown to him.

Therefore, it can be said – assuming that the annual publication of the certificate in a newspaper will be the practice accepted by the authorities – that the new procedure certainly represents a step towards the elimination of unfair treatment and clearly demonstrates the goodwill of the Japanese authorities.

However the discrimination between FBs and Japanese banks still remains. The discrimination consists in the requirement of obtaining the certificate in order to receive interest gross. The reasoning is simple: FBs do not require a certificate (stating that they are a permanent establishment in Japan of a foreign bank) in order to be liable for the payment of income tax and local tax; it is the law itself that states that permanent establishments of foreign entities are subject to taxation for the profits realised in Japan. In other words, FBs do not need a certificate to pay taxes, but they do need it in order to receive interest gross. To be consistent, FBs should 'obtain' a certificate before being liable for Japanese taxes (and the lack of it – for any reason whatsoever, including a clerical error – should release them from such obligation).

Obviously, this is paradoxical, but why? The *fact of being* a permanent establishment of a foreign company in Japan is *per se* sufficient (and no other requirements, such as a certificate, are necessary) to qualify under the law as a permanent establishment and, therefore, to be subject to income and local taxes. The *same fact* is not sufficient to qualify as a permanent establishment in order to receive interest gross, but it is necessary that the authorities certify that they are such!

Some may argue that the different treatment is due to the fact that the payer having seen the certificate is not required to verify it, whether the receiver of interest is qualified as a permanent establishment in Japan or not. However this argument does not seem to be strong enough, since FBs are licensed to do business in Japan and the fact that they have a licence is publicly available. Payers could simply check this information instead of receiving a certificate, which involves a cumbersome administrative procedure and implies an unfair treatment for the FB.

In other countries, in fact, the approach is very simple. For instance, in Italy interest paid by residents to Italian branches of foreign banks is not subject to withholding tax, hence there is no need for a tax certificate or any administrative procedure (Article 26, Decree 600 of 29 September 1973). The law implies that the payer of interest is responsible for checking – although no requirement is set regarding how the checking should be done – that the receiver is an Italian branch of a foreign bank. This check can be done in any way, from an actual visit and knowledge of the permanent facility to the inspection of the public records, to checking with the central bank, and so on.

As to withholding tax, there is one aspect which it is not possible to avoid in any legal system: *the agent, which is the source of income, must bear the responsibility of checking. Now, the kind of checking can make the difference. In Japan the responsibility is with the agent, but the burden of checking is with the interest rate receiver, who has to provide the certificate to the agent, hence do the checking on its behalf.*

The ideal solution would be the complete abolition of the certificate (or a photocopy): only in this way would the discrimination be eliminated. What seems to be the most unfair aspect of the current regime is the provision described above for a specific criminal offence for something which should not be the foreign bank's responsibility in the first place.

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