Journal of INTERNATIONAL BANKING LAW

VOLUME 9 ISSUE 11 NOVEMBER 1994 ISSN 0267-937X

CONTENTS

OPINION

Reporting Financial Information by Segment: The IASC's Draft Statement of Principles
RUSSELL COLLINS, MELANIE FITZSIMONS AND RICHARD PARLOUR

ARTICLES

Consumer Electronic Banking
CHRIS REED

The Regulation of Investment Firms in the European Union (Part 2)
RICHARD DALE

Ostensible Ownership and Motor Vehicle Financing in England: Antipodean Insights
IWAN R. DAVIES

Anton Pillers and Marevas in Hong Kong
RICHARD MORRIS

LEGAL ANALYSIS

The Withholding Tax Certificate for Foreign Banks in Japan
FRANCESCO CAPUTO NASSETTI

Exclusion of the Equitable Right to Contribution between Co-guarantors: Recent Australian Developments
JACQUELINE LIPTON

How French Banks Sweep Bad Real Estate Debts from their Balance Sheets
PHILIPPE PORTIER

NEWS SECTION

An International Review of Cases and Recent Legislation

BOOK REVIEWS

Sweet & Maxwell
ESC PUBLISHING

LEGAL ANALYSIS

LEGISLATIVE DEVELOPMENTS & CASE REVIEWS

The Withholding Tax Certificate for Foreign Banks in Japan

Francesco Caputo Nassetti
Avvocato, Tokyo

The Japanese financial market is totally controlled by domestic institutions, and the foreign bank's market share is negligible. Several different obstacles are the reason for such status. This analysis considers one subtle example of unequal treatment: the combination of regulation and market practice creates a paradoxical situation, which may have large consequences for minor oversights.

Under the Japanese Income Tax Law (Article 212, Law 33 of 1965) an interest payer is required to withhold tax on interest payments if the recipient is a foreign corporation.

There is, however, an exemption (Articles 180 and 214) 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 ('the FCPF') (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 of interest, the withholding tax is not applicable and interest can be paid gross.

It is felt that this regulatory framework creates unequal treatment from three different perspectives: the administrative perspective, the legal perspective and the market perspective.

The Administrative Perspective

Branches of foreign banks in Japan ('FBs') fall within the definition of FCPF and are required, if they want to receive interest payment gross from their Japanese resident borrowers, to follow the procedure described below:

> The FB must collect an application form and a certificate form from the local tax office, fill them in with details of the applicant and the borrower and return them to the tax office.
>
> After receipt by the bank the certificate is sealed by the competent tax officer – this process usually takes two weeks – and the bank must send the original certificate to the borrower. The FB normally asks for a written acknowledgement of this and/or keeps a photocopy of the certificate for its records.
>
> Although the law does not set any limit on the validity of the certificate, the administrative practice limits its duration to five years.
>
> In order to ease the administrative burden of monitoring the maturity dates of a large number of certificates, several FBs adopt a system called 'synchronised end dates' by which all certificates bear the same end date. Although there is an obvious advantage in having only one maturity date for a number of certificates, a disadvantage is the fact that certificates issued to new customers have a duration shorter than five years: any new customer receives a certificate which expires on the prefixed end date of all certificates (if, for example, the new relationship starts just before the general end date, a new certificate is soon due).
>
> Although the law is not clear on this point, if the borrower or the FB changes name or address, a new certificate or a written communication to the tax office is advisable.

Taking into account the large number of customers (corporate bodies and individuals), and the volume of loan transactions which a bank normally handles, it is obvious that the above procedure is administratively cumbersome and time-consuming. The FB has to assign staff members to this job and any clerical mistake may have expensive consequences, as will be seen below.

Since an FB must obtain a banking licence in order to engage in banking business in Japan and for the extension of loans to Japanese residents, its competitive ability is impaired in comparison with Japanese banks which are not required to follow the above procedure for the obtaining of a withholding tax certificate. Borrowers may prefer to avoid doing business with an FB because of the additional paperwork involved, the record-keeping requirements and the duty of checking the existence of a valid certificate before executing any payment of interest to an FB – matters which do not arise when dealing with Japanese banks.

The system also puts an FB at a disadvantage when it deals in the short-term money market with a counterparty for the first time: offered an interesting lending rate, the FB would be unable to grant

the loan unless it already had an existing, valid certificate.

The Legal Perspective

The principle of establishing a duty of withholding tax is to ensure that tax is collected by the Japanese tax authorities from the foreign corporation with respect to the domestic (that is, Japan) sourced income.

If the recipient has no facilities or assets in Japan it may be difficult to collect the tax in case the payment is made in full – hence the mechanism of the withholding tax to ensure the collection of tax.

However, in the case of an FB, the granting of the banking licence requires the bank to hold a certain amount of assets in Japan, a minimum capital and reserves and so on, and FBs are, obviously, required to pay taxes on their income (including the income arising from loans to non-residents in Japan). Accordingly there are assets available for enforcement by the tax office as in the case of Japanese banks.

Therefore the reasoning behind the need to withhold tax is simply not there in the case of an FB.

The legislation is considered unequal because FBs have to face ongoing costs to justify the benefit of a very legitimate exemption. As the FBs are income tax payers duly licensed, there cannot be any uncertainty or ambiguity for the borrowers whether to apply the withholding tax or not. In other countries the withholding tax is simply not due if the recipient of interest is an FB established in the same country.

In addition, the withholding tax would not be imposed if foreign banks were allowed to undertake banking business in Japan through Japanese subsidiaries. However, the Ministry of Finance does not allow this arrangement for legal reasons.

The withholding tax requirement is considered unequal also because the banking licences are granted under the General Banking Law as applied to all banks licensed to operate in Japan, and not a special law applicable to foreign banks only.

The Market Perspective

In order to fully understand the paradoxical situation in which FBs are put, it is necessary to underline some furether aspects of the above legislation.

It is clear that there is no obligation for an FB to obtain and supply to the borrower the withholding tax certificate. In fact the FB willing to receive interest gross has the right to carry out the procedure described above. On the other hand the interest payer has a legal obligation to apply the withholding tax in case the certificate is not delivered.

If for any reason a borrower who does not have the exemption certificate pays interest gross, then the borrower is required to (re)pay to the fiscal authority the amount of interest which should have been withheld, plus a delinquent tax computed at the rate of 14.6 per cent per annum from the day following the statutory due date and the actual payment date (such rate is reduced to 7.3 per cent for the first two months of delay). He is also liable for a penalty, which amounts to 10 per cent of the withholding tax.

While the borrower is entitled to claim from the receiving bank the withholding tax amount and the relevant delinquent tax, he is not entitled to claim the above penalty for which he is solely liable. The bank is entitled to a tax credit equivalent to the withholding tax paid, thus being able to recover at least the withholding tax amount (but not the delinquent tax accrued on it).

In theory, therefore, the system is fair and consequential with its premises: the bank is penalised by the delinquent tax accrued on the withholding tax amount and by the fact that it has to bear the funding cost of the withholding tax amount until its reimbursement from the tax authorities. The borrower is penalised by the penalty.

However, market practice is quite different: due to the large number of FBs, borrowers and transactions, it is not uncommon that an FB fails to deliver a certificate *and* the relevant borrower fails to withhold the tax (even in the best-managed organisation a clerical mistake might happen).

Although the responsibility for the penalty is only with the borrowers, the latter – especially the large corporations – consider the tax certificate a 'bank's matter' to be taken care of by banks only. In fact, their view is that, *in order to consider FBs at the same level of domestic banks*, the issuance, handling and delivery of the certificate is something that they should not have to worry about. Therefore, if something goes wrong, the FB is expected to pay everything, *penalty included*.

If, on the other hand, corporations had to bear the cost of the penalty, they would be likely to set up an internal checking system before making each payment to the FB.

For a large corporate body working with several banks, this would be cumbersome and expensive. The easiest solution to avoid this hassle would be not to work with an FB at all. If an FB wants to be considered at the same level of domestic banks, it has to pay for the borrowers' mistakes, hence the discriminatory treatment.

The situation is even more unfair in that the FB has no right to negotiate with the tax authorities (which deal only with the borrower and refuse to negotiate with the FB) and there is no real incentive on the part of the borrower to negotiate with the tax authorities.

In the light of the above corporate 'logic', it has become a general (although not absolute) market practice for the FB to reimburse the customer for the related penalties when this circumstance occurs.

Conclusion

In the frame of the Japanese Government's efforts to tackle the traditional regulatory barriers, foreign banks have increased their lobbying in an attempt to eliminate discriminatory treatment such as the above certificate.

It is clear that the current system is not only an administrative burden requiring ongoing labour cost; it also implies a high liability in case a small formality is omitted. The imposition of the penalties further creates a possible increase in costs, which will impair the competitive power of the FB (even if the penalty is not reimbursed by the FB to the borrower – for example, if the relationship has already been terminated among the parties – the FBs are at a competitive disadvantage due to the fact that borrowers realise that this risk is not present when dealing with domestic banks).

Other countries have adopted a much simpler approach: 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 tax certificates or any other administrative procedure (Article 26, Decree 600, of 29 September 1973).

Another solution would be a general waiver issued by the tax authorities for each bank (with or without a periodical review) or an indefinite duration of the certificates issued for each customer. In this latter case it seems that a change in the current system could be swiftly implemented without a change in the legislation.

The handling by the Japanese authorities of this issue will be another test of their willingness to eliminate unequal treatment and to open their market to fair and sound competition.

Exclusion of the Equitable Right to Contribution between Co-guarantors: Recent Australian Developments

Jacqueline Lipton
Legal Services Unit, Australia and New Zealand Banking Group Limited, Melbourne

This analysis observes that the right of contribution in equity is based on notions of fairness and justice between parties who have undertaken a common burden. In light of this observation, the principles relating to a co-surety's right to contractually exclude the equitable right are critically examined in relation to co-guarantors in a commercial context, with particular reference to recent Australian case law developments.

Introduction: The Equitable Right to Contribution

The equitable right to contribution in Anglo-Australian case law is based on notions of fairness and justice. One of the earliest statements describing the basis of the right was that of Lord Chief Baron Eyre in *Dering v Earl of Winchelsea*:[1] 'contribution is bottomed and fixed on general principles of justice'.[2] In more recent Australian case law, various members of the High Court have identified similar bases for the right to contribution. In *Mahoney v McManus*,[3] Gibbs CJ stated that 'the doctrine of contribution is based on the principle of natural justice that if several persons have a common obligation they should as between themselves contribute proportionately in satisfaction of that obligation'.[4] This view has also been supported by text-book writers in the area. Phillips and O'Donovan have noted: 'The common burden of the suretyship should be borne equitably so that no guarantor can be required, between himself and his co-sureties, to pay more than his due share. In this light, the right to contribution is firmly founded upon natural justice and equitable principles'.[5]

The right to contribution will generally arise between two or more persons who are each responsible for the same primary obligation of another person to a third party. Where the third party has called on one of those persons for payment, that

1. (1787) 29 ER 1184.
2. *Ibid.*, at 1185.
3. (1981) 36 ALR 545.
4. *Ibid.*, at 551.
5. Phillips J and O'Donovan J, *The Modern Contract of Guarantee*, (2nd edn), The Law Book Company, 1992, at 526 to 527.