Cross-border Corporate Reorganizations and Non-discrimination Clauses

－Focusing on Two Protocols in Japanese Tax Treaties－

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Abstract:

There have been arguments for improving the flexibility of tax treaties for cross-border issues arising from corporate reorganizations. This article focuses on non-discrimination clauses, and reviews present situations on Japanese tax treaty conclusion policy for corporate reorganizations. Then, this article clarifies current issues of its policy, mainly based on an internationally well-known Professor Domingo's scholarly work.

Only two protocols of current Japanese tax treaties have non-discrimination clauses for corporate reorganizations. If the assets leave the tax jurisdiction of the state of source through corporate reorganizations, such two protocols exclude preferential tax regimes for such reorganizations at the state of source from non-discriminately treatments.

From this study, it follows that existing tax treaties (including the OECD Model) have two issues on non-discrimination clauses for corporate reorganizations: (1) Existing non-discrimination clauses (e.g. article 24 of the OECD Model) have no valid grounds to envisage preferential tax treatments for corporate reorganizations; (2) Practices of some states when negotiating their bilateral tax treaties might support the interpretation favouring the inclusion of corporate reorganizations within the scope of the relief of non-discrimination clauses.

In conclusion, this study shows two following findings: (1) Current Japanese tax treaty conclusion policy for non-discrimination clauses can be evaluated as normal responses in line with the OECD Model; (2) Practices of above-mentioned two protocols can be reference options for Japan as well as Australia and New Zealand when negotiating Japanese bilateral tax treaties.

For the second finding, it is worth noting that such non-discriminatory treatments have to be discussed as part of the overall system of international income taxation as Professor Masui points out. It seems that the relationship between such non-discriminatory treatments and article 13 of the OECD Model is important and that such treatments show examples of how that relationship should be.

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I. Introduction

There have been arguments for improving the flexibility of tax treaties for cross-border issues arising from corporate reorganizations. This article focuses on non-discrimination clauses, and reviews present situations on Japanese tax treaty conclusion policy for corporate reorganizations. Then, this article clarifies current issues of its policy, mainly based on an internationally well-known prior scholarly work (hereinafter; Professor Domingo's scholarly work)[1].

This article proceeds as follows. Part II shows transactions as premise in this article, and explains an issue for the purpose of the tax treaty policy and introduces its possible solutions. Part III reviews Japanese tax treaty conclusion policy for non-discrimination clauses, and introduces two protocols of 2008 Japan-Australia tax treaty and 2012 Japan-New Zealand tax treaty. Part IV mainly introduces Professor Domingo's scholarly work regarding non-discrimination clauses for corporate reorganizations. Part V shows results from this study and discussion based on such results. Part VI provides concluding remarks.

II. Improving the flexibility of tax treaties for cross-border issues arising from corporate reorganizations

1. Transactions as premise in this article

The importance of tax treaties has increased significantly in recent years as a consequence of the globalization of the economy and the liberalization of cross-border trade and investment[2]. From October 23 to 25, 2001, an invitational seminar on the future of tax treaties was held in the new premises of the International Bureau of Fiscal Documentation (IBFD) in Amsterdam[3] (hereinafter; IBFD seminar).

1) Domingo Jesús Jiménez-Valladolid de l'Hotellerie-Fallois, Reorganization clauses in tax treaties, IBFD, 2013. He is a professor of financial and tax law at the Autonomous University of Madrid.
2) Brian J. Arnold, Jacques Savverville, and Eric Zolt, "Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century", 50 Can. Tax J. 65, 2002, at 65.
3) *Id*.

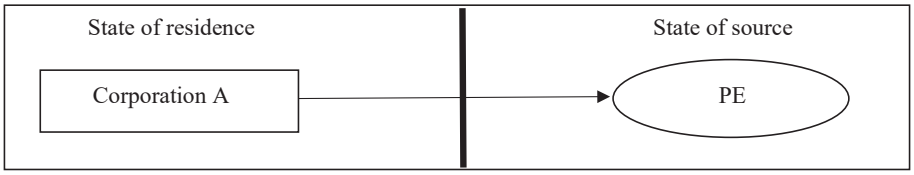

Figure 1 Pre-reorganization

Figure 1[4] and Figure 2[5] show transactions as premise at the IBFD seminar. I'd like to argue them as starting point, too. In chronological order, firstly, corporation A has a Permanent Establishment (hereinafter; PE) situated in the state of source (see Figure 1). Secondly, corporation A contributes a branch of activity to the capital of corporation B (see Figure 2).

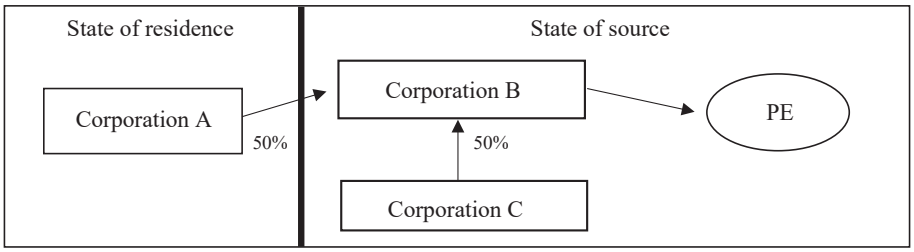

Figure 2 Reorganization

Professor Gugliemo Maisto describes as follows:

'In several states, relief otherwise available in respect of reorganizations effected solely by resident companies is denied if the parties to the reorganization are non-residents. … For instance, a resident company contributing a branch of activity to the capital of another resident company may be entitled to rollover relief, but the same relief may be denied to a non-resident company contributing a permanent establishment situated in the territory of the state[6].'

From such descriptions, it is evident that the reorganization in Figure 2 arises a non-discrimination issue.

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4) Figure 1 is made by the author, referring to Brian J. Arnold, Jacques Savverville, and Eric Zolt, *supra* note 2, at 142, FIGURE 2 (Gugliemo Maisto).

5) Figure 2 is made by the author, referring to Brian J. Arnold, Jacques Savverville, and Eric Zolt, *supra* note 2, at 142, FIGURE 2 (Gugliemo Maisto).

6) Brian J. Arnold, Jacques Savverville, and Eric Zolt, *supra* note 2, at 141-142 (Gugliemo Maisto).

2. Possible solutions

Firstly, Professor Gugliemo Maisto describes as follows:

'The extent to which article 24(3) applies to these situations needs to be explored. Indeed, it could be argued that article 24(3) deals with issues of discriminatory treatment of the income attributable to a permanent establishment itself, while in the case at issue the denial of the rollover relief does not affect the income attributable to the permanent establishment (the permanent establishment is the object of the contribution). This issue is not expressly addressed by the commentary on 24 of the OECD model[7].'

Then, he insists possible solutions that either the commentary or article 24 might be changed[8].

By the way, article 24(3) of the OECD Model Tax Convention on Income and on Capital (hereinafter; the OECD Model) is called 'PE Non-discrimination'. It states:

'3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.'

The commentary of the OECD Model was replaced on 17 July 2008. Para 41 of Article 24(3) states:

'41. As clearly stated in subparagraph c) above, the equal treatment principle of paragraph 3 only applies to the taxation of permanent establishment's own activities. That principle, therefore, is restricted to the comparison between the rules governing the taxation of permanent establishment's own activities and those applicable to similar business activities carried on by an independent resident enterprise. It does not extend to rules that take account of the relationship between an enterprise and other enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership) since the latter rules do not focus on the taxation of an enterprise's own business activities similar to those of the permanent establishment but, instead, on the taxation of a resident enterprise as part of a group of associated enterprises. Such rules will often operate to ensure or facilitate tax compliance and administration within a domestic group. It therefore follows that the equal treatment principle has no application. For some reasons, rules related to the distribution of the profits of a resident enterprise cannot be extended to a permanent establishment under paragraph 3 as they do not relate to

7) Brian J. Arnold, Jacques Savverville, and Eric Zolt, *supra* note 2, at 142 (Gugliemo Maisto).

8) *Id*.

the business activities of the permanent establishment (see paragraph 59 below).'

It is evident from such commentary that article 24(3) of the OECD Model does not extend to rules that take account of the relationship between an enterprise and other enterprises (e.g. rules that allow tax-free transfers of property between companies under common ownership)[9].

III. Non-discrimination clauses in Japanese tax treaties

1. Japanese tax treaty conclusion policy regarding non-discrimination clauses

Non-discrimination in domestic law needs to be considered in arguments about non-discrimination clauses in international tax law[10]. In Japan, non-discrimination is covered by the equality clause of the constitution[11]. Although fairness in determining "ability to pay" is a principle of taxation, in Japan, constitutional guarantees of equality apply to ability to pay[12].

Next, I'd like to introduce non-discrimination clauses of Japanese tax treaties in chronological order. In 1959, Japan introduced a non-discrimination clause for the first time in its tax treaty with Pakistan[13]. Then, Japan introduced detailed non-discrimination clauses in its tax treaty with Norway and Denmark in 1959[14]. In this way, the insertion of non-discrimination clauses have become part of Japanese tax treaty conclusion policy[15]. However, reasons for including non-discrimination clauses in bilateral tax treaties are not so obvious[16].

Moreover, for non-discrimination clauses, Japanese tax treaties have fundamentally four provisions, which are non-discriminatory treatments for nationality, PE, deductibility and ownership[17]. However, there are some Japanese tax treaties that don't have a deductibility

9) Although it was a case not related to corporate reorganizations, there was a case concerning article 24(3) of the India-Japan Double Taxation Avoidance Agreement [Mitsubishi Corporation India Pvt. Ltd v. DCIT (I.T.A. No.: 5042/Del/11) (Delhi Tribunal) on 2014]. The Indian Tax Tribunal ruled in favour of the taxpayer. See, KPMG, India Tax Konnect, 3, December 2014, https://assets.kpmg/content/dam/kpmg/pdf/2014/12/ITK-December2014.pdf (last retrieved Jan. 27, 2022).

10) Tadatsune Mizuno, Japan, in IFA, *Cahiers de droit fiscal international: Non-discrimination rules in international taxation*, Vol.78b, 511, 1993.

11) *Id*.

12) *Id*.

13) Yoshihiro Masui, "*Nikokukan Sozei Joyaku jouno Musabetsu Joko* [*Non-discrimination Clauses on Bilateral Tax Treaties*]", RIETI Discussion Paper Series 10-J-051, 10, 2001. As background of introduction of the non-discrimination clause, Professor Masui shows information that Japan had no treaty of commerce and navigation with Pakistan then.

14) Yoshihiro Masui, *supra note 13*, 10.

15) *Id*.

16) Yoshihiro Masui, *supra note 13*, 2.

17) Go Kawada and Masako Tokunaga, *2017 OECD Moderu Sozei Joyaku Komentari- Chikujo kaisetsu* [*Article-by-article Comments on 2017 OECD Model Tax Convention Commentary*] (4th edition), 587, 2018.

non-discrimination provision[18].

By the way, Japan-United States tax treaty shows a direction of Japanese tax treaty policy[19]. However, it doesn't have the non-discrimination clause for corporate reorganizations. Therefore, two following protocols with Australia and New Zealand seem to be exceptional.

2. Japan-Australia tax treaty

Though Japan-Australia tax treaty was concluded in 1970, it was revised in 2008 to increase flows of trade and investment aggressively in the light of the close economic relationship between Japan and Australia[20].

Subparagraph 21(g) of the protocol with reference to the non-discrimination clause (article 26 of the 2008 Japan-Australia tax treaty) states:

'21. With reference to Article 26 (Non-Discrimination) of the Convention: It is understood that nothing in the Article shall be construed as restricting the application of any of the following provisions of the laws of Australia: …

g) Section 122-25 of Part 3-3 of Chapter 3 of the ITAA 1997, which does not permit the deferral of tax arising on the transfer of an asset, where the subsequent transfer of the asset by the transferee would be beyond the taxing jurisdiction of Australia under its laws; …'

As an affirmative provision, such explanation describes subparagraph 21(g), which contravenes non-discrimination provision of article 26 of the new tax treaty[21].

3. Japan-New Zealand tax treaty

Though Japan-New Zealand tax treaty was concluded in 1963, it was revised in 2012, as it was inappropriate for the then economic relationship between Japan and New Zealand[22].

Subparagraph 15(f) of the protocol with reference to the non-discrimination clause (article 25 of the 2012 Japan-New Zealand tax treaty) states:

'15. With reference to Article 25 of the Convention: It is confirmed that the provisions of Article 25 of the Convention shall not affect the provisions of the taxation

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18) *Id*.

19) Tadatune Mizuno (eds), *Kokusai Kazei no Riron to Kadai 2* [*Theories and Issues of International Taxation*] (2th edition), 35 (Masatugu Asakawa), 2005.

20) Ministry of Finance, JAPAN, *Heisei 20 Nendo Zeisei Kaisei no Kaisetsu* [*Explanation on FY2008 Tax Reform*], 528, https://warp.da.ndl.go.jp/info:ndljp/pid/9551815/www.mof.go.jp/tax_policy/tax_reform/outline/fy2008/explanation/pdf/P527-P585.pdf (last retrieved Jan. 27, 2022).

21) Ministry of Finance, JAPAN, *supra* note 20, 560-561.

22) Ministry of Finance, JAPAN, *Heisei 25 Nendo Zeisei Kaisei no Kaisetsu* [*Explanation on FY2013 Tax Reform*], 769, https://warp.da.ndl.go.jp/info:ndljp/pid/9551815/www.mof.go.jp/tax_policy/tax_reform/outline/fy2013/explanation/pdf/p0753_0833.pdf (last retrieved Jan. 27, 2022).

laws of New Zealand concerning:…

(f) Subpart FO of the Income Tax Act 2007 which deals with amalgamation of companies; …'

As an affirmative provision, such explanation describes subparagraph 15(f), which contravenes non-discrimination provision of article 25 of the new tax treaty[23].

4. Preceding Studies and their Limits

Firstly, regarding positioning of this article between Japan with the respect to the whole research in Japan, above-mentioned explanations[24] pick up on such two protocols. However, such explanations are only overviews. This article solely utilizes such two protocols as one of research materials to clarify current issues on Japanese tax treaty conclusion policy regarding the non-discrimination clause for corporate reorganizations. Maybe, Professor Masui's discussion paper[25] is a preceding study of this article. This discussion paper gives very useful suggestions for the non-discrimination clause of Japanese tax treaty conclusion policy. Especially, Professor Masui points out that there is a high risk of ending up in a "leap into the darkness", if expanding the scope of non-discrimination clauses in bilateral tax treaties is not discussed as part of the overall system of international income taxation. However, such discussion paper does not refer to relationship between the non-discrimination clause and corporate reorganization.

Secondary, regarding positioning of this article with the respect to the whole research except for Japan, Professor Domingo's scholarly work is a main preceding study. This work focuses on problems for corporate reorganizations in tax treaties.

Naturally, however, such work describes nothing about current issues of Japanese tax treaty conclusion policy, though two above-mentioned protocols are described in that work. Therefore, this article examines current issues of Japanese tax treaty conclusion policy regarding the non-discrimination clause for corporate reorganizations in the light of such survey by Professor Domingo's scholarly work.

IV. Introduction of Professor Domingo's scholarly work

1. Article 24(3) of the OECD Model

For a transfer of a PE under commentaries of the OECD Model replaced on 17 July 2008, Professor Domingo describes as follows:

'…The issue of whether the case of a transfer of a PE would fall within the scope of the non-discrimination clause envisaged in article 24(3) of the OECD Model so as to benefit from preferential tax regimes provided by the domestic laws of the state of

23) Ministry of Finance, JAPAN, *supra* note 22, 800.

24) *See* Ministry of Finance, JAPAN, *supra* note 20, 560-561; Ministry of Finance, JAPAN, *supra* note 22, 800.

25) Yoshihiro Masui, *supra note 13*, 1-22.

source has been addressed in the 2008 update to the Commentaries of the OECD Model. With this update, the OECD clarifies that the application of a tax-free regime for the transfer of a PE is not included within the scope of the non-discrimination clause respecting PEs.'

However, Professor Domingo points out that the interpretation promoted in the commentaries might still be controversial[26].

(1) The first argument in favour of the extension of the relief provided in article 24(3) to preferential tax regimes for reorganizations is literal interpretation[27]. For instance, it is argued that the expression "taxation on a permanent establishment" does not imply that only the items of income or capital formally attributable to the PE are to be considered within the scope of the non-discrimination clause[28].

(2) The second argument in favour of the inclusion of the relief provided for transactions when they involve a transfer of a PE within the scope of the non-discrimination clause is based on the object and purpose of this provision[29]. In this respect, this clause promotes, to a certain extent, the capital import neutrality respecting the target markets[30].

(3) The third argument supporting the extension of the non-discrimination relief for PEs in the case of their transfer in the course of a cross-border reorganization is based on the systematic of article 24[31]. Because article 24(3) is often regarded as being parallel to the provision found in article 24(5) respecting the non-discrimination against foreign controlled companies[32].

After examining the above three arguments (literal interpretation, teleological interpretation, and systematic interpretation), Professor Domingo comes to the conclusion that there are no valid grounds for the argument that the transfer of a PE in the course of a foreign reorganization would fall within the scope of the non-discrimination clause envisaged in article 24(3) of the OECD Model.

2. Comments on such two protocols in Japan

Professor Domingo pays attention to the fact that practices of some states when negotiating their bilateral tax treaties might support the interpretation favouring the inclusion of corporate reorganizations within the scope of the relief of the non-discrimination clause[33]. Professor Domingo focuses on Australia and describes as follows:

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26) Professor Domingo's scholarly work, *supra* note 1, 163.
27) *Id*.
28) *Id*.
29) Professor Domingo's scholarly work, *supra* note 1, 164.
30) Professor Domingo's scholarly work, *supra* note 1, 164. As similarly stated, H.J. Ault and J. Sasseville, Taxation and Non-Discrimination: A Reconsideration, 2 World Tax Journal 22, 102, 2010.
31) Professor Domingo's scholarly work, *supra* note 1, 165.
32) *Id*.
33) Professor Domingo's scholarly work, *supra* note 1, 163.

'it is worth noting that Australia has included specific provisions in its tax treaty network in order to exclude from the non-discrimination provision the denial of application of tax deferral in the case of transfers of assets outside its jurisdiction (see the Australian tax treaties with United Kingdom (2003, article 25(6)); Finland (2006, article 23(5)); Norway (2006, article 24(6)); Japan (2008, Protocol subpara. 21); South Africa (2008 Protocol to the 1999 treaty, article 23(A)(5)); New Zealand (2009, article 24(5)) and Turkey (2010, article 24(6)).[34]'

In the above-mentioned context, subparagraph 21(g) of the protocol to 2008 Japan-Australia tax treaty is introduced.

Then, Professor Domingo describes as follows:

'The argument a contrario would imply that tax deferral is applicable in a transfer of assets unless the assets leave the tax jurisdiction of the state of source.[35]'

Moreover, for subparagraph 15(f) of the Protocol to 2012 Japan-New Zealand tax treaty, Professor Domingo describes as follows:

'A similar provision is included in the 2012 tax treaty between New Zealand and Japan (subpara 15(f) of the Protocol with reference to the non-discrimination clause (article 25 of the treaty) in order to exclude the application of the non-discrimination clause to the preferential tax regime for amalgamations envisaged in New Zealand's domestic legislation so long as its application does not derive in a different tax treatment of residents in Japan compared to residents of third states.[36]'

As mentioned above, Professor Domingo insists that subparagraph 15(f) of the protocol to 2012 Japan-New Zealand tax treaty is similar provision to subparagraph 21(g) of the protocol to 2008 Japan-Australia tax treaty, although former provision does not contain any description of cases in which right to tax at the state of source are lost.

V. Result and Discussion

1. Result

From this study, it follows that existing tax treaties (including the OECD Model) has two issues on non-discrimination clauses for corporate reorganizations: (1) Existing non-discrimination clauses (e.g. article 24 of the OECD Model) have no valid grounds to envisage preferential tax treatments for corporate reorganizations; (2) Practices of some states when negotiating their bilateral tax treaties might support the interpretation favouring the inclusion of corporate reorganizations within the scope of the relief of non-discrimination clauses.

Incidentally, subparagraph b) of article 25(5) of Australia-New Zealand tax treaty states:

34) Professor Domingo's scholarly work, *supra* note 1, 387, footnote 705.
35) *Id.*
36) *Id.*

'5. This Article shall not apply to any provision of the laws of a Contracting State which: …

b) does not permit the deferral of tax arising on the transfer of an asset where the subsequent transfer of the asset by the transferee would be beyond the taxing jurisdiction of the Contracting State under its laws; …'

In this provision, the term "the laws of a Contracting State" is so placed that subparagraph b) is applicable to both contracting states. This point clearly differs from 2008 Japan-Australia tax treaty and 2012 Japan-New Zealand tax treaty, as former is only applicable to the laws of Australia and latter is only applicable to the laws of New Zealand.

2. Discussion

(A) Finding 1－Evaluation of the current situation as consistent with the OECD Model (Considerations based on the first result)

As long as existing non-discrimination clauses (e.g. article 24 of the OECD Model) have no valid grounds to envisage preferential tax treatments for corporate reorganizations, most of Japanese tax treaties can be evaluated as normal responses in line with the OECD Model.

Accordingly, 2008 Japan-Australia tax treaty and 2012 Japan-New Zealand tax treaty should be evaluated as exceptional. Rather, these tax treaties should be evaluated only as accepting tax treaty conclusion policies of the other contracting state (Australia and New Zealand).

(B) Finding 2－Possibility of alternative in Japan when negotiating Japanese bilateral tax treaties (Considerations to the second result)

Two protocols with Australia and New Zealand have provisions regarding non-discrimination clause for corporate reorganizations. As Professor Domingo points out, it seems that there is room for tax deferral treatments as long as right to tax at the state of source are not lost. In my opinion, inserting such a provision into non-discrimination clauses of Japanese tax treaties could be considered as one of the tax treaty conclusion policy options, provided that right to tax at the state of source (namely, Japan) is not lost[37]. Concretely speaking, it seems worth considering such inserting as an option in bilateral tax treaty negotiations with other contracting states where Japan expects increase of inward

37) See, Office of Prime Minister, June 3, 2020, "Infrastructure Systems Overseas Expansion Strategy 2025 (June 2020 Supplement)" https://www.kantei.go.jp/jp/singi/keikyou/dai54 /infra.pdf (last retrieved Jan. 27, 2022). Page 85 states:

'We should try to solve problems and improve the business environment by utilizing international legal frameworks such as economic partnership agreements, investment agreements, and tax treaties, as well as bilateral conferences <Ministry of Foreign affairs, Ministry of Finance, Ministry of Economy, Trade and Industry, Ministry of Land, Infrastructure, Transport, and Tourism>.'

The term "tax treaties" is clearly indicated. It can be said that this information is based on the same idea as this article in terms of utilizing tax treaties for policy purposes.

flows of trade and investment to Japan through corporate reorganizations.

By the way, such my opinion means expanding the scope of non-discrimination clauses in bilateral tax treaties. Therefore, in order not to end up in a “leap into the darkness”, which Professor Masui points out, such non-discriminatory treatments have to be discussed as part of the overall system of international income taxation. Concretely speaking, such non-discriminatory treatments contribute to avoidance of international double taxation, which is one of primary objectives of bilateral tax treaties. In my view, whether such non-discriminatory treatments finally serve under article 13 of the OECD Model has to be discussed. Article 13 of the OECD Model provides allocation for tax revenue between contracting states for capital gain taxation. As such non-discriminatory treatments are related to capital gain taxation for corporate reorganizations at the source country, it seems that the relationship between such non-discriminatory treatments and article 13 of the OECD Model is important and that such treatments can be evaluated as examples of how that relationship should be. I’d like to discuss detail on this matter in another paper.

VI. Conclusions

This article focuses on non-discrimination clauses, and reviews present situations on Japanese tax treaty conclusion policy for corporate reorganizations. Then, this article clarifies current issues of its policy, mainly based on an internationally well-known Professor Domingo’s scholarly work.

From this study, it follows that existing tax treaties (including the OECD Model) have two issues on non-discrimination clauses for corporate reorganizations: (1) Existing non-discrimination clauses (e.g. article 24 of the OECD Model) have no valid grounds to envisage preferential tax treatments for corporate reorganizations; (2) Practices of some states when negotiating their bilateral tax treaties might support the interpretation favouring the inclusion of corporate reorganizations within the scope of the relief of non-discrimination clauses.

In conclusion, this study shows two following findings: (1) Current Japanese tax treaty conclusion policy for non-discrimination clauses can be evaluated as normal responses in line with the OECD Model; (2) Practices of above-mentioned two protocols can be reference options for Japan as well as Australia and New Zealand when negotiating Japanese bilateral tax treaties. For the second finding, it is worth noting that such non-discriminatory treatments have to be discussed as part of the overall system of international income taxation as Professor Masui points out. It seems that the relationship between such non-discriminatory treatments and article 13 of the OECD Model is important and that such treatments can be evaluated as examples of how that relationship should be.

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